The Guessing Game

How will the U.S. play agriculture trade in 2007

Political activity to revive global trade talks has created a buzz in Geneva. Trade officials and journalists are all trying to find out whether U.S. Trade Representative (USTR) Susan Schwab will make a new offer and, if so, what it will look like. The U.S. is the world's largest trading power and its negotiating position is decisive for the conclusion of the WTO's Doha Agenda.

So far, the U.S. has shown less willingness than other WTO members to change its position. Now a complicated web of issues and interests is being spun inside the U.S. The web deserves attention. The elements include a new sense of public distrust that trade is an effective engine for economic prosperity; low approval ratings for the Bush administration undermining its political effectiveness; a Republican Party damaged by scandals; the outcome of the 2006 congressional elections that gave the Democratic Party control of both chambers of Congress; the imminent expiry of "fast track" negotiating authority, without which agreement on a trade deal is almost impossible; the renewal of the Farm Bill in mid-2007; and rising world commodity prices linked in part to the explosion of political interest and economic investment in biofuels to reduce dependency on oil. All these factors affect the USTR's approach to global trade talks.

The following set of questions and answers offers some guidance through the tangled web of U.S. trade policy for 2007.

THE POLITICAL MOOD IN THE U.S.

Have Americans lost faith in trade as an economic mainstay?

Expanding foreign markets and associated free trade rhetoric no longer has the political appeal that it once did in the U.S. In agriculture, it is clear that domestic needs are driving the farm economy, not exports. But this is also the case in a lot of other industries. The U.S. has lost so many jobs in both agriculture and manufacturing that Americans are starting to question whether exports offer a viable path to prosperity. A number of polls and studies conducted in the U.S.—including those by the University of Maryland, Greenberg Quinler Rosberg Research and Public Agenda—confirm this trend.[1] Members of Congress are much less likely to make achieving agreement on the Doha Agenda a priority given this context—and are less likely to compromise with the Bush administration. The WTO deal is a tough sell politically in the U.S., with few visible gains outside the larger U.S.-based transnational companies who remain committed advocates of deeper tariff cuts for all countries.

How is a Democratic majority in Congress likely to address trade?

Even Democrats traditionally supportive of free trade have little incentive to give President Bush a victory by helping the administration complete the Doha Agenda. They are more likely to wait until after the 2008 election, hoping to gain a USTR appointed by a Democratic president. Until then, Congress is less

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likely to approve the renewal of fast track negotiating authority and more likely to object to compromises in agriculture, both of which are necessary to the conclusion of the Doha Agenda.

How will the new Farm Bill impact the U.S. position at the WTO?

Farm Bill negotiations are in full swing and on January 31, U.S. Secretary for Agriculture Mike Johanns announced the USDA's proposals for how it would like to see the Farm Bill reformed. Congress is expected to complete a new Farm Bill by July 2007. Meanwhile, negotiations on the Doha Agenda are fast running out of time. The expiry of fast track in June 2007 will preclude a quick decision on a deal unless fast track is extended. President Bush is asking for a fast track renewal but is now contending with a hostile Congress. If a Doha deal looked likely, there would be significant pressure on Congress to modify U.S. farm programs to meet WTO demands (most importantly by setting new ceilings on spending, particularly on programs that link to commodity prices.) However, given how little movement there has been in the Doha talks since they collapsed in July 2006, it seems foolish to count on that pressure as a way to bring about what will be difficult compromises domestically on agricultural spending. The Farm Bill debate is likely to be almost entirely about domestic politics and the outcome will likely further constrain what USTR can propose in the give and take of the WTO's trade negotiations, which span a number of sectors simultaneously.

There will almost certainly be cuts to spending that conform to the kind of direction WTO member states are asking for, but they are not likely to be enough to help members reach agreement. Nor will they resolve the most pernicious aspects of U.S.-caused trade distortions in world agricultural markets.

What about the interests of the manufacturing, retail and services sectors in the U.S.?

Other industries besides agriculture are exerting pressure to get a deal. Statements by trade associations such as the U.S. National Association of Manufacturers continue to press the administration to get a deal. These voices point out that agriculture is too small a share of U.S. gross national product for it to hold other sectors of the economy to ransom. These companies may view 2007 as their last chance to get a deal under a more business-friendly Republican president. Their leadership is concerned that a delay might mean a Democratic president would take office, complicating the negotiations because the Democrats are committed to greater protection in trade agreements for both the environment and labor standards.

A NEW AGRICULTURE OFFER?

What could a new offer look like and what would it really add up to?

The messages coming from the Bush administration related to reforms to domestic agricultural programs are confused. For example, although Agriculture Secretary Mike Johanns recently made one set of recommendations for changes to the Farm Bill (released on January 31), a few days later, the budget proposed by the same Bush administration cut funding for programs that Johanns had proposed to expand. The proposals are just proposals—ultimately Congress is the legislative arm of the U.S. government, and it is Congress that will approve both the budget and the renewed farm legislation. The current Congress is in no mood to do President Bush's bidding.

Most of the controversial (Amber Box) subsidies are tied to world prices. With many commodity prices high and climbing, government support payments are automatically reduced, which makes it much easier for the U.S. to conform to its Amber Box ceiling and to offer deeper cuts in the negotiations. This happened in the last round too—the Uruguay Round committed the U.S. to cutting its Amber Box support to $19 billion over five years, but supply-related shortages sent prices sky-high in 1995-96, and the U.S. was able to meet that $19 billion target in the first year because farmers did not need the safety-net payments. Then emergency spending gradually increased again as commodity prices fell dramatically through the late 1990s and into 2000 and 2001. This fluctuation in actual outlays on agricultural support needs to be understood; it is at least as important to know what the rules allow (how high might spending go if prices were to fall?) as to know the actual expenditure level of a given year (which is related to world price—supply and demand—at any given time).

Some highlights of Johanns' proposal are worth a mention in light of the Doha negotiations. First, Johanns' plan includes a $5.5 billion increase over 10 years to the program of direct payments. These payments are linked only to historic production levels and so are eligible for Green Box status, which sets no limit on spending. The proposal is careful to say that, unlike in 2002, base levels (which set the level of direct payments a farmer is eligible to receive) would not change so as to ensure the green box status. There is absolutely no way for Johanns to guarantee this money would actually be granted, but there is also nothing in the WTO rules or the Doha proposals to stop the U.S. government paying these monies if they chose to.

Johanns also proposed to change the existing system of countercyclical payments, which were established in 2002 to provide a kind of minimum price for producers. The proposal would replace the existing price-based system with a revenue-based system, using a complicated calculation that takes yield as well as price into account. The proposal is to use historically fixed prices, base acres and yields in a bid to avoid being categorized as an Amber Box program. Payments would presumably be classified as Blue Box, since they would use a historically determined baseline but would fluctuate according to each year's price and yield figures. The proposal is an

implicit acknowledgement that agriculture markets are highly volatile and will often push market prices down below farmers' cost of production. So instead of using traditional policy tools to set a fair market price, a revenue-based program will allow a system of low commodity prices to continue along with high government payments. Congress thus far has been skeptical of a revenue-based approach, although the proposal has some powerful supporters.

Which sectors or constituencies in the U.S. will be most affected?

The current subsidy system benefits cotton and rice farmers above all others. Those farmers are located primarily in a few Southern states—states that are today Republican strongholds. Although the programs make little economic sense, it will be difficult politically to make cuts that will hurt these farmers the most, especially as 2008 is a presidential election year. Republicans will fight hard for every vote they can keep. Aspects of the USDA proposals of January 31 would hit cotton and rice growers the hardest—particularly the limits on the size of payments individual farm operations are eligible for, as rice and cotton farmers get the largest checks. Such proposals are the least likely to make it through Congress, although payments may take on a new guise.

THE BROADER PICTURE

Will the rise in world commodity prices have any bearing on the USTR's position?

World commodity prices have risen in the past year and will continue to rise in 2007. Two major world shifts explain the current spike: the enormous growth in corn-based ethanol production, and the massive increase in demand for commodities from China and other emerging economies like India.

For the past few years, corn, soybean and wheat prices were well below the cost of production, resulting in high levels of farm payments in the U.S., which in turn made U.S. agricultural subsidies a bone of contention in the international community. But this past year has been the most prosperous for Midwest agricultural communities in a decade. The high price of corn due to increased ethanol production is lifting both corn prices and those of other crops as overall demand increases. Simultaneously and automatically, higher market prices push U.S. farm subsidies down. Several types of U.S. farm policies are tied to price. When market prices rise above a government-determined price, subsidies stop (the programs are only meant to provide a safety-net when prices are low). In 2005, when corn prices were low, U.S farm subsidies skyrocketed to $24 billion. But in 2006, as the strong demand for ethanol took effect, subsidies dropped to around $16 billion.[2]

It's expected that subsidies will drop still further in 2007. Ethanol demand has driven up corn prices from $2.60 a bushel in September 2006 to $4.20 for March 2007 purchases. And with more farmers planting corn to take advantage of the ethanol boom, soybean production is down, pushing prices up from $5.63 in September '06 to $7.28 for March '07 purchases.[3] Even cotton farmers in Southern states are switching over to corn, a move likely to cut cotton production and exports. Although experience tells us that such price spikes are generally followed by increased production and subsequent price falls, U.S. negotiators will find it easier to get political acceptance for deeper cuts to domestic support programs in the prevailing market than they did in the 2002 Farm Bill debate, which came after five years of depressed commodity prices.

Increased demand for commodities is also lifting prices. Demand for feed grains (for livestock) from Asia, particularly, from China, is booming while, for now, growth in Latin America has slowed. Some factors, such as a poor wheat harvest in Australia, are also affecting supply; it is too soon to know whether this might mark new difficulties for drought-prone Australia or is just a meteorological blip.

Many U.S. farm groups and policymakers believe that the current high prices are now a permanent fixture, particularly because congressional leaders and the president are considering a renewable fuels standard that would quintuple biofuel production in the next ten years. Demand from Asia is unlikely to slow down any time soon either.

The last time prices were this high was in 1995. This encouraged farmers to support the 1996 Farm Bill, known as Freedom to Farm, which aimed at dismantling U.S. commodity programs. Prices started to fall in 1997 and kept falling to some of the lowest levels (adjusted for inflation) since the 1930s. Congress completely reversed course and subsequently provided some of the largest farm payments ever seen. Today's high prices for commodities could quiet the concerns that many U.S. farm organizations have about the Doha Agenda and provide the USTR with more flexibility to offer further reductions in domestic support. However, farmers have also learned from experience and are less willing to gamble on continued high prices given the volatility of commodity markets and the continuing trend towards concentrated market power among both input suppliers and the grain processors who buy their crops.

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