Potential Implications of a Trans-Pacific Partnership for the Canadian Pork Industry

Executive Summary

- This paper illustrates the importance to the Canadian economy of pork exports, with a particular emphasis on exports to Japan. More specifically the paper discusses the significance of Canada being a successful member in the Trans-Pacific Partnership in which Japan and the United States are key pork industry participants.
- Canadian pork exports represent over 60% of total Canadian pork production and are thus a critical component of the success of the industry. During 2014, Canada's pork exports amounted to $3.4 billion dollars.
- Statistics Canada's Input-Output model shows that Canada's pork exports generated total gross output for pork processors, hog farmers and industry suppliers of nearly $11 billion and create about 46,000 jobs in Canada across the entire country.
- Canada's trade to Japan of $868 million generates $2.8 billion in gross output value for pork processors, hog farmers, and industry suppliers. Japanese exports generate 12,000 jobs.
- The value of Japanese exports amounting to $4.91 per kilogram is more than two times the total Canadian pork carcass cutout value of about $2.30/kg. The added value of the Japanese market could not be made up in another market or compensated if lost.
- If Canada were not part of a major TPP agreement in which the U.S. and Japan were signatories on pork, Canada could lose at least $330 million or much more in export sales. The loss of just $330 million in sales represents about a billion in total economic activity in Canada and about 4,500 jobs at jeopardy. A loss of that magnitude to Japan would represent a loss in value to producers of about $5 per head.
- If Canada were a part of a major agreement with Japan, the benefits would be material. Even a modest 10% increase in tonnage would mean an additional $87 million per year in exports to Japan. An added $87 million in sales translates to over a quarter billion dollars in added economic activity and well over 1,000 new jobs. That is conservative however, as plausible scenarios could include gains of $300 million in sales and another 4,000 jobs. Hog producers could see added benefits on a per head basis due to added volume and the Japanese premium.
- The added value of the Japanese market could not be made up in another market or compensated if lost. A scenario where the U.S. gains a significant market access advantage over Canada for pork into Japan would potentially lead to major negative shifts in the Canadian pork sector. Without the ability to compete in the most lucrative overseas market, Canada's processors/exporters would not be able to sustain the competitive pressure from the U.S. and would ultimately face shutdowns. This loss would equate to billions in lost economic activity and thousands of jobs in Canada.

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Purpose and Objective

The purpose of this paper is to demonstrate the importance of Canada joining a Trans Pacific Partnership (TPP) agreement that includes pork, with a particular focus on the Japanese market.

The two main objectives are as follows:

1. Illustrate trends and economic value of the pork trade with Japan and other TPP participants.
2. Demonstrate positive and negative results to the Canadian pork industry of certain plausible scenarios of TPP outcomes.

Importance of Pork Trade to Canada

This section of the report provides perspective on the importance of Canada's pork trade to both the industry and to Canada as a whole. The section provides perspective on the size and trends in Canada's pork trade. It also discusses the impact of pork trade on farm prices, jobs and overall economic activity in Canada.

The purpose of this section is to illustrate how crucial pork trade is to Canada and the importance of progress and success in the TPP for the industry.

Overview

Canadian pork exports represent over 60% of total Canadian pork production and are thus a critical component of the success of the industry. During 2014, Canada's pork exports amounted to $3.4 billion dollars. The total value in 2014 was a new record while the tonnage volume was close to the record established in 2012. The point of emphasis is that Canada's pork export performance has been consistently robust and growth oriented.

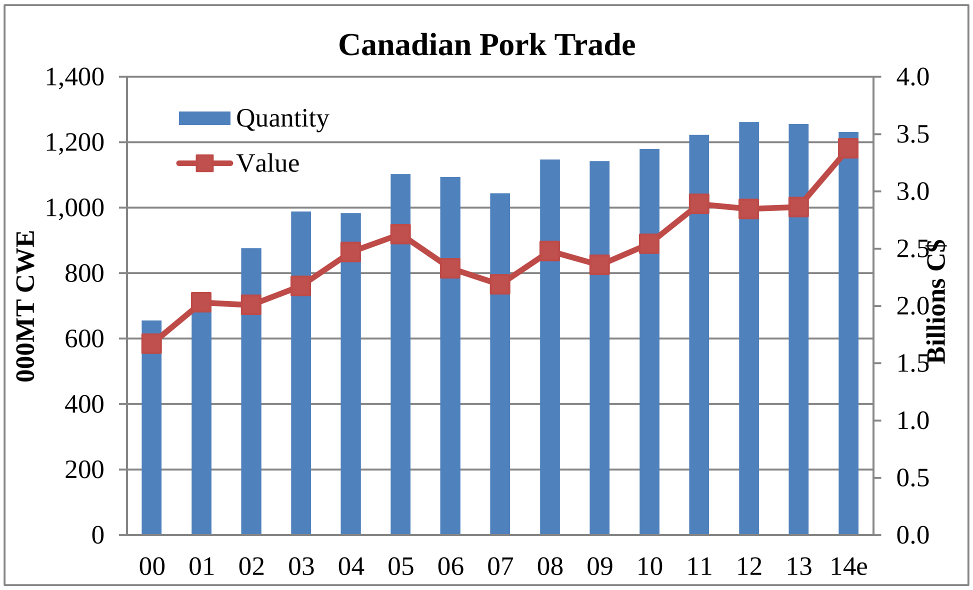

Figure 1

Of that \$3.4 billion total value, \$2.7 billion or 80% is exported to TPP member countries. The United States exports at nearly \$1.4 billion, represents about 40% of total Canadian export value and half the total value of TPP exports. Japanese exports of \$868.4 million represent 26% of the value of total Canadian exports, and one third of the value of TPP exports. All non-U.S. TPP member countries represent 40% of total Canadian exports.

The key message is that with regard to value, the TPP member countries represent a very important component of Canada's pork exports and thus are crucial to the Canadian industry.

Export Economic Impact

Pork Trade Impact on the Economy

Statistics Canada's Input-Output models can be used to measure the economic contribution of a particular economic activity, in this case pork exports. Utilizing the Statistics Canada model reveals that Canada's pork exports of \$3.4 billion in 2014 generated total gross economic activity for pork processors, hog farmers and industry suppliers such as packaging manufacturers of nearly \$11 billion. The net contribution to Canada's Gross Domestic Product (GDP) as a result of exports amounts to \$3.8 billion. Canadian pork exports generate about 46,000 jobs in Canada across the entire country according to the Statistics Canada model.

Pork trade with TPP partners of \$2.7 billion generates \$8.7 billion in gross output value for pork processors, hog farmers, and industry suppliers. The TPP exports generate nearly 37,000 Canadian jobs.

Importance of Japanese Pork Trade

Japanese Trade Impact on the Economy

Japanese pork trade in itself is a major contributor to the Canadian economy. Canada's trade to Japan of $868 million generates $2.8 billion in gross output value for pork processors, hog farmers, and industry suppliers. The export sales to Japan alone contribute nearly a billion dollars in GDP to Canada. These Japanese exports generate 12,000 Canadian jobs.

Japanese Pork Trade Value

Japanese trade amounted to 176 million kilograms in 2014. The per kilogram value of $4.91 is by far the largest per unit value of all of Canada's major pork trading partners. Japanese export values on a per kilogram basis is more than two times the value of exports to China and Mexico and nearly two times more valuable than trade to South Korea.

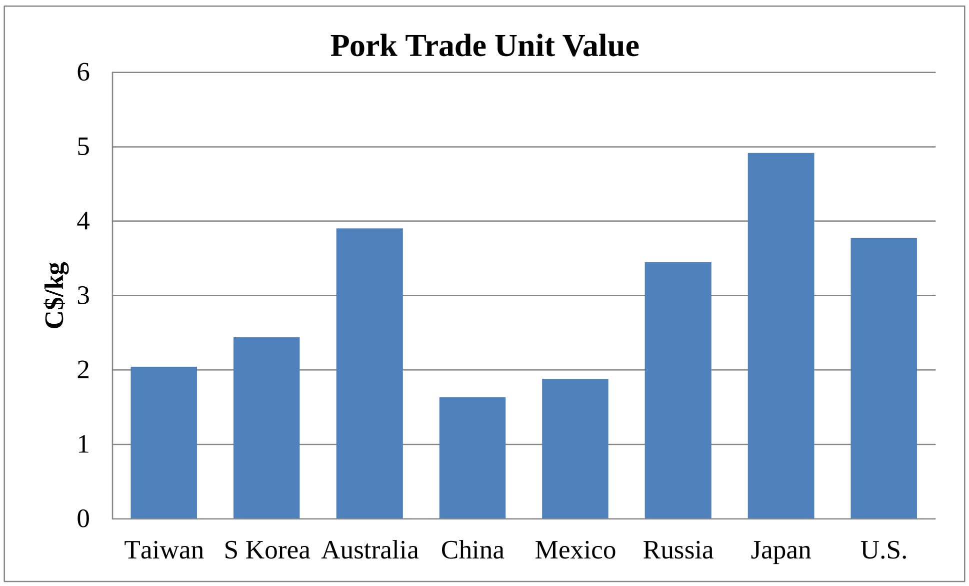

Figure 2

Value to Hog Farmers

Pork trade in general is obviously crucial to the financial prospects of Canadian hog farmers. Trade to Japan in particular is of great importance due to the higher value of the pork products exported to that country.

Japanese sales of $868 million dollars amounts to about $34/head in for each of the 25 million hogs marketed in Canada during 2014. As noted above, Japanese exports are the highest valued exports on a per kilogram basis for Canada. The value of Japanese exports amounting to $4.91 per kilogram, is more than two times the total Canadian pork carcass cutout value of about $2.30/kg.

Because of this added value to Japan, that market is of proportionally greatest importance of all Canadian export markets. The premium or added value of those Japanese exports of more than two times the overall cutout adds disproportionate value to the Canadian hog and pork industry. For example, total Canadian pork production amounted to about 1.96 billion kilograms (carcass basis) in 2014. Japanese exports amounted to about 11% of that total Canadian production.

With regard to value, there is no publicly available estimate of total Canadian fresh and processed pork production values, but based on 2014 carcass values and estimated total production at the packer level, the value is approximately $4.5 billion or more. Japanese exports, of $868 million amount to about 19% of the value at the packer level. Japanese value is nearly two times greater than its volume. This is an extraordinary point of note for this market.

Another way to look at the importance of Japan is to consider its added value relative to the cutout average value for all sales. For example if the overall value of the Japanese shipments was just $2/kg greater than the overall cutout, it would add about $10-15 per head in added value to Canadian hog producers. This is an important point of reference. That is, consider that as noted above, Japanese sales amount to $35/head. Arguably, if the Japanese market was lost, the tonnage could and would be generated in other markets (after severe disruption). The added value of the Japanese market, of about $2/kg compared to the total carcass however, could not be made up or compensated if lost. That point needs to be emphasized as no other global market can generate the kinds of returns that Japan generates. As such, it is not a case of simply moving product to an alternative.

Potential Scenarios

There are a wide variety of possible outcomes for the Canadian pork industry in the TPP negotiations with regard to Japan. This section of the report outlines two possible or plausible scenarios and circumstances regarding Japan and discusses their implications. The purpose of this section is not to exhaust or address a large number of possible scenarios. Instead the purpose is simply to provide perspective on a generally positive or a generally negative outcome to TPP for Canadian pork.

<u>Background:</u>

> *In 2007, Japan agreed to reduce the 4.3% pork duty to 2.2% for Chilean pork. The reduced duty was applied to a quota of 32,000 mt rising to 60,000 mt by year 5.*
>
> *In 2012, the Japan-Mexico Economic Partnership Agreement cut the tariff on Mexican pork from 4.3% to 2.2% (Quota)?*
>
> *In 2014, Japan agreed to cut the tariff on Australian pork to 2.2% from 4.3%, within a quota of 6,700 metric tons in the first year rising to 16,700 tons within five years.*

These three agreements have given preferential duties to Chile, Mexico, and Australian pork, but the simple duty cut from 4.3% to 2.2% while keeping the gate price, offers negligible benefits as seen on the Figure 3. Mexico received this preferential access in 2012. While they have seen their volumes increase, they remain a small supplier to the market. Chile received this modest advantage in 2007 and have yet to increase their market share of pork into Japan.

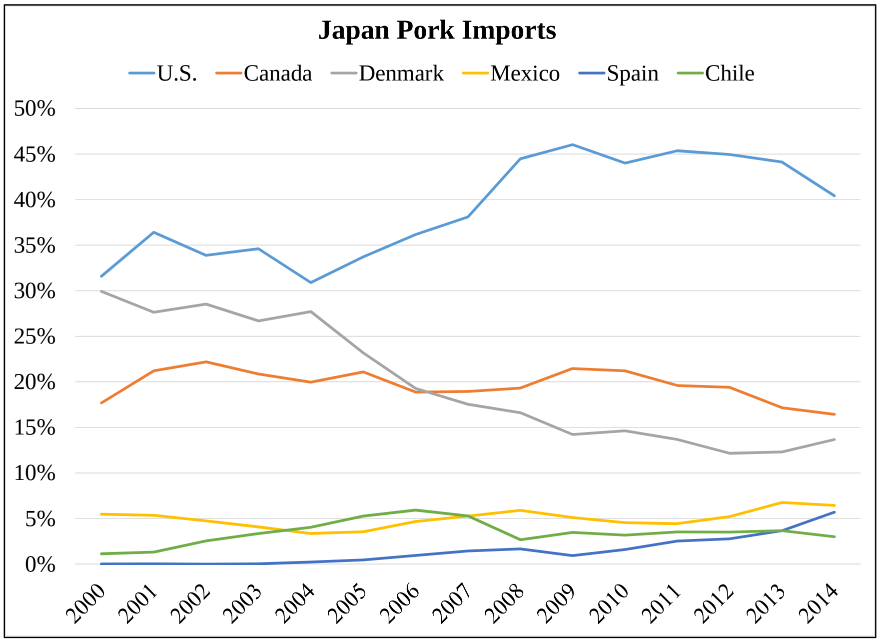

Figure 3

Scenario 1 Both Canada and Japan are Participants

<u>Modest Result</u>

One scenario for consideration is that the outcome of the TPP negotiations attains what would be considered a "modest result." Such a modest change for example would be the elimination of the Japanese tariff and modest safeguard changes. This would be a result similar to FTAs Japan has with Mexico, Australia and Chile. Other modest results would include the following:

- Removal of the 4.3% duty but the gate price remains at ¥524/kg

Even under this modest scenario, however, key gains would be made by U.S. and Canada. This level of access would put the U.S. and Canada on equal footing with the access previously granted to Mexico and Chile. This scenario would not shift the market share balance of imported pork between the U.S. and Canada as both would gain the new access. However both would give slight advantage to the U.S. and Canada versus the EU. The European Union would stand to lose share as it would not be included in this modest outcome.

Robust or Major Result

A reasonably plausible major result for the pork industry would be the tariffication of the gate price and reduction of that by half or more.

This significant lessening in Japan's pork import regime would accelerate the reduction of domestic pork production and also accelerate the rate of imports into Japan. As long as this agreement treats U.S. and Canadian pork the same, there is not a significant advantage for either U.S. or Canadian pork. The obvious disadvantage would be to pork from the EU, Mexico, Chile and Brazil.

Japan's pork consumption is currently comprised 50% from imports. Significant liberalization of Japan's wholesale market would lead to increased liquidation in the Japanese pig sector and production declines. Obviously the phaseout period will define the speed of liquidation.

Scenario 2 Japan is a Participant, Canada is Not

Modest Result

Under this scenario, while Canada is not a participant, Japan agrees to a modest reduction in import duties/gate price. This would be the removal of the 4.3% duty but the gate price remains at ¥524/kg.

Assuming that this scenario includes a U.S. / Japan bilateral agreement, this scenario would obviously penalize Canada versus the U.S. As U.S. and Canadian pork products are somewhat homogenous, any preferential advantage to U.S. pork will lead to declines of Canadian pork in the Japanese marketplace.

That being said, this access was granted to Mexico and Chile in 2012. Both are minor suppliers and have not seen significant shifts in market share since the access was granted.

Robust or Major Result

Under this scenario, Canada again is not participating but there is a reasonably major reduction in import duties/gate price for the U.S. This scenario would lead to a rapid loss in Canadian market share, the speed of which would be defined by the speed of phase-downs. EU suppliers would also face falling market shares in the face of rapid growth in U.S. market share.

This scenario with a modest reduction would be similar to Canada's loss of market share in the S. Korean pork market following the U.S. / Korean FTA as shown on Figure 4.

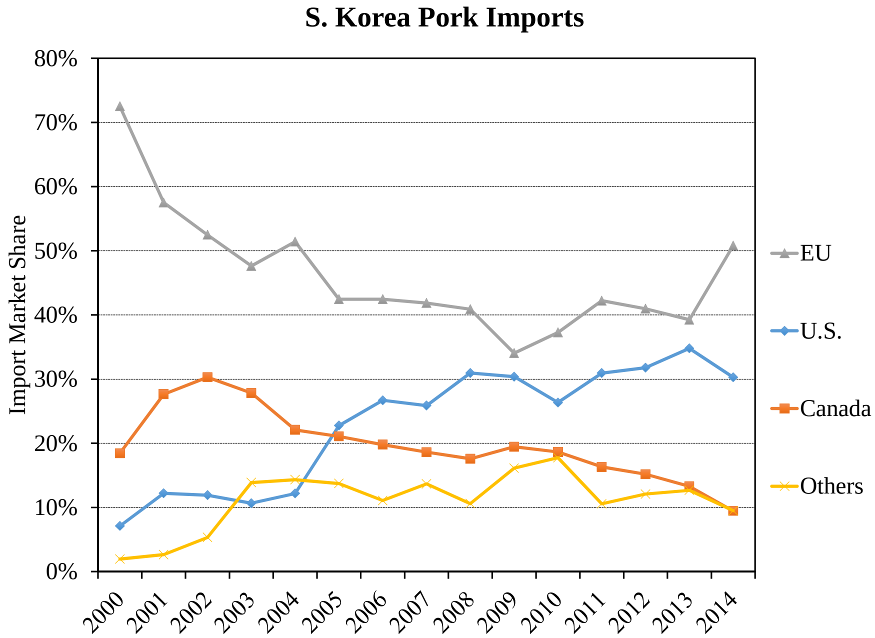

Figure 4

Sales Gains and Losses

<u>Impact of Lost Japanese Sales: The Korean Example</u>

One way to examine the impact of lost sales to Japan is to consider the example of Korea. As is widely acknowledge there was a negative impact on Canada given that the United States signed a trade agreement with Korea and Canada did not. Tariffs of 20-25% on US shipments were reduced and eliminated for the United States while Canadian duties remained. This provided a material competitive advantage for the United States. According to a Congressional Research Service report from September 2014, the National Pork Producers Council expected the agreement to “be one of the most lucrative for the U.S. pork industry,” with a substantial increase projected in exports to South Korea, live hog prices, and direct jobs.

The agreement came into force in 2012 and had an immediate and negative impact on Canadian exports to Korea. From 2011 to 2014 Canadian sales to Korea declined by 57% on a tonnage basis. Interestingly the surge in exports in 2011 as seen on Figure 5 had to do with the November 2010-April 2011 FMD outbreak and ban on moving hogs within Korea. Canadian packers reacted very quickly to the FMD outbreak and outperformed their US counterparts by shipping huge quantities of pork to Korea during the Jan-April period.

On a value basis, the decline from 2011 to 2014 was 58%. In the meantime, total Canadian pork exports, as shown on Figure 1 are steady to modestly increasing. In other words, the Korea case stands out mainly due to the lack of a competitive trade deal relative to the United States.

If the 2011 to 2014 comparison is seen as too stark to be representative of the impact given the FMD issue noted above, the message is similar even considering the average of 2006-2010 as the norm in trade between the two countries. Comparing 2006-2010 average to trade in 2014 shows that tonnage is down by 38% and by 22% on a value basis. Lost tonnage is nearly 25 million kilograms while lost value amounted to $27 million.

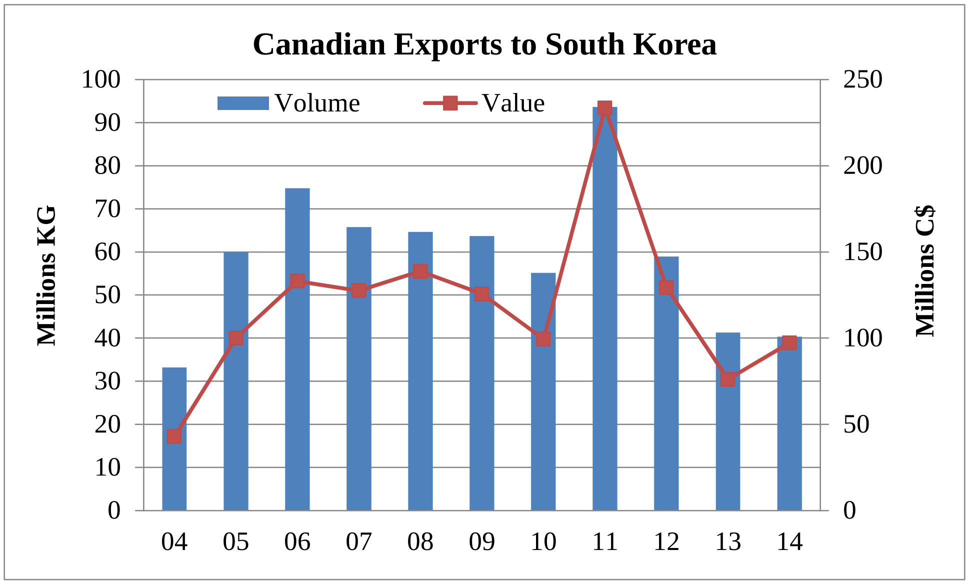

Figure 5

If similar circumstances were to occur such that the United States and Japan came to an agreement but Canada did not, the results would be much more damaging for Canada. First of all, as noted on Figure 2, the per unit value of Japanese exports, at nearly $5/kg is about two times greater than Korea. A 38% drop in volume to Japan, as occurred with Korea, would represent value of, about $330 million compared to the $27 million with Korea.
As a point of reference, the loss of $330 million in sales represents about a billion in total economic activity in Canada and about 4,500 jobs at jeopardy. Furthermore, the reduction of 38% should be considered conservative. The U.S. would likely pursue its Japanese opportunities with far greater assertiveness than in the Korean example.

Furthermore, the Korean value per kilogram is roughly on average with the overall cutout while the Japanese value is much greater. A loss of the magnitude of 38% to Japan would represent a loss in value to producers of about $5 per head.

In addition from a packer marketing perspective, while Korea is important, Japan is critical. Japan takes a wide variety of cuts from the pork cutout. Korea is more of a market for frozen fill-in products. Japan is a central destination for the cutout, Korea is a market for periphery products.

In summary while Canada’s demise in S. Korea following the U.S. / Korean FTA can be used as an example of what could happen in Japan, there is a major difference. Japan is a much larger, more advanced pork market with significantly higher premiums. The export profits from Japan likely outweigh the collective export profits of the other pork markets combined. [In 2005, a USMEF study showed that Japan accounted for 75% of the U.S. pork industry's "export premiums" while Korea accounted for only 37% of U.S. pork export tonnage.]

The major difference in comparing Japan and S. Korea is that Japan provides a substantially more lucrative market for Canada's pork producers. This higher price generates substantially more profits for Canadian exporters than shipments to S. Korea.

This impact cannot be understated: No other overseas market success can compensate for a failure in Japan.

Potential for Sales Gains Within TPP

The potential gains for Canada within a robust TPP deal is difficult to estimate. As noted above, it is reasonable to take EU market shares lower and allocate that lost market share between the U.S. and Canada at a historical ratio. The question however would be how hard would the EU share be cut in that scenario. In 2014 the US had 40%, Canada had 16%,and the EU had 32%. If over 10 years, the EU loses half of their market shares (from 32% to 16%, and that is allocated at the existing U.S./Canada balance (71%/29%), then the outcome would appear as on Figure 6.

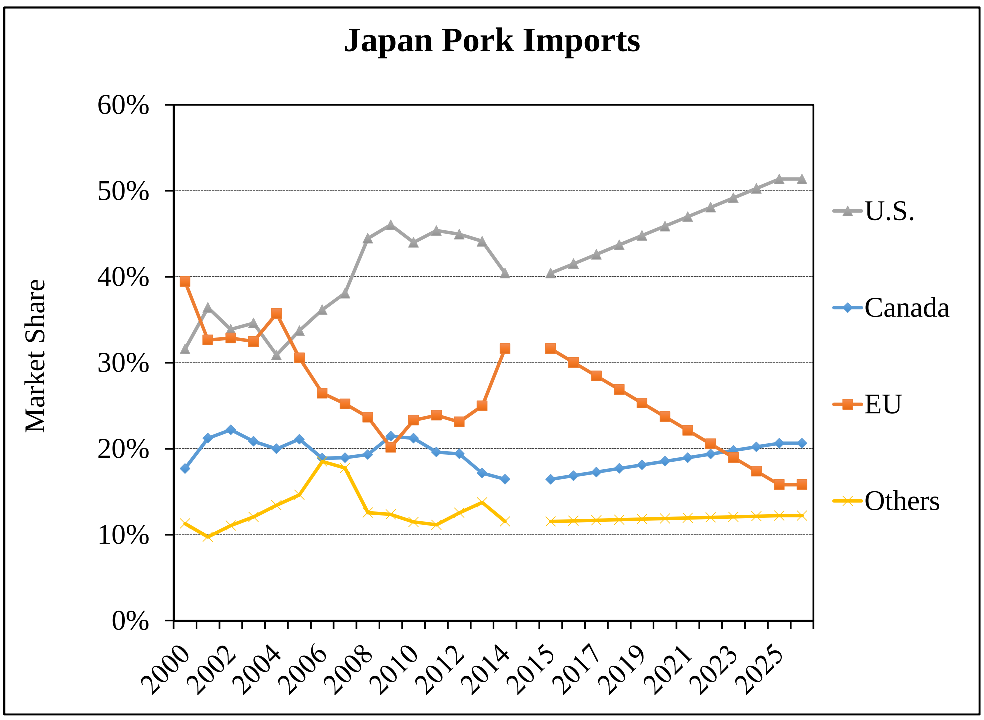

Figure 6

This doesn't look as interesting for Canada as the U.S. At the same, however, time it would be difficult to justify Canada increasing market share against the U.S. during this time period.

Another way to consider possible gains is in estimating production losses in Japan due to market liberalization. As with the above, however, there is no real defensible way to estimate this without some major assumptions. Estimates within Japan and knowledgeable industry experts suggest that pure market liberalization could lead to 90% of Japanese production stopping in 10 years. That is unlikely, but there is no good way to estimate production losses from a “substantial” increase in market access.

With all of the above acknowledged, the prospects are positive for Canada with liberalization and that is the main point. For example, even if Canada could increase its exports to Japan by just 10% in volume after an aggressive change in the trade regime, it would have significant benefits for the Canadian pork industry. A 10% increase in tonnage would mean an additional $87 million per year in exports to Japan. An added $87 million in sales translates to over a quarter billion dollars in added economic activity for Canada and well over 1,100 new jobs.

Canadian hog producers could see added benefits on a per head basis of another dollar per head due to the added volume and the Japanese premium.

If Canada were in a TPP deal which included significant reductions in protection, it is easy to argue that the gains for Canada would be higher than those shown above. If the Japanese production loss was 50% of their herd, and Europe declined by 50% (probably more), that would be $1-2 billion of pork up for grabs. If we only got 20% that still would be $300 million in additional sales. That translates to nearly $1 billion in economic activity and 4,000 new jobs.

In addition the processing sector may be a significant winner in the trade deal. Currently very little is shipped there because of the gate price and duties. If they come down at a similar rate, all new markets for value added products would be available. These labour intensive opportunities with high value sales are an even better story than fresh and frozen pork for that market. Sales in Japan for processed products are significant and with Japanese pork production declining, they will need to source more processed products as well.

Summary Considerations

Canada’s pork industry has faced significant challenges over the past 15 years. Located geographically right next door to the U.S. with liberalized trade under NAFTA, Canadian processors have smaller plants (lower processing speeds), higher labor costs, and lower by-product valuations, yet they have been able to compete successfully with the U.S. in international markets. Canada’s success story lies in their producer/exporter’s ability to diversify and target higher-value market segments overseas. Japan represents the vast majority of that success. The key market where Canada’s pork producers have been able to fetch export premiums necessary to sustain their level of production, is Japan.

A scenario where the U.S. gains a significant market access advantage over Canada for pork into Japan would potentially lead to major shifts in the Canadian pork sector. Without the ability to compete in the most lucrative overseas market, Canada’s processors/exporters would not be able to sustain the competitive pressure from the U.S. and would ultimately face shutdowns. The U.S.

processors would then seek more hogs to fulfill their rising Japanese demand. Canada's pork producers remain competitive in hog production but without plant processing capacity in Canada, would become raw material suppliers (hogs) to the U.S. processing sector. Canada would lose out on the value-added component of processing hogs into pork and further valued-added pork products, along with the associated jobs and economic activity centered around their current processing industry. This loss would equate to billions in lost economic activity and thousands of jobs in Canada.

More specifically, if Canada were not part of a major TPP agreement in which the U.S. and Japan were signatories on pork, the U.S.-Korea trade deal could be used as a guide. In that case, a 38% drop in Canadian volume to Japan, as occurred with Korea, would represent value of, about $330 million compared to the $27 million with Korea. As a point of reference, the loss of $330 million in sales represents about a billion in total economic activity in Canada and about 4,500 jobs at jeopardy. Furthermore, the reduction of 38% should be considered conservative. The U.S. would likely pursue its Japanese opportunities with far greater assertiveness than the Korean example. Furthermore, the Korean value per kilogram is roughly on average with the overall cutout while the Japanese value is much greater. A loss of the magnitude of 38% to Japan would represent a loss in value to producers of about $5 per head.

Canada and the USA operate in an integrated pork market. Therefore any deal that disadvantages Canada's pork carcass cutout value or advantages the US cutout will strengthen the US's competitive advantage everywhere Canada competes against them. Higher returns in Japan would allow US packers to be aggressive (price) in other markets including their exports to Canada.

Conversely, if Canada were a part of a major agreement with Japan, the benefits would be material. For example, even a modest 10% increase in tonnage would mean an additional $87 million per year in exports to Japan. An added $87 million in sales translates to over a quarter billion dollars in added economic activity for Canada and well over 1,000 new jobs. That is conservative however, as plausible scenarios could include gains of $300 million in sales and another 4,000 jobs. Canadian hog producers could see added benefits on a per head basis of another dollar per head due to the added volume and the Japanese premium.

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