October 2018

From NAFTA to USMCA

Implications of the new U.S.-Mexico-Canada trade agreement for American agribusiness

Prepared by CoBank's Knowledge Exchange Division

Inside...

Executive Summary

The North American free trade pact isn't dead after all. Up against a hard deadline on September 30, Canada and the U.S. struck a deal that should keep the tripartite trade agreement in place. This follows the preliminary agreement established between the U.S and Mexico on August 27. NAFTA is given a makeover in content as well as name – now called the United States-Mexico-Canada Agreement, or USMCA. And the agreement reflects some new and some old – a combination of original NAFTA, terms that were negotiated for the defunct Trans-Pacific Partnership (TPP), and new text that addresses the complexity of global trade as it exists today.

If ratified as expected next year, USMCA will bring the greatest amount of change to the auto industry. But agriculture has a lot at stake too. All food and agricultural products that have zero tariffs under NAFTA will remain at zero tariffs under USMCA. For sectors like grain and biofuels, the goal of USMCA was just that – preservation of tariff-free trade. But the dairy, animal protein and specialty crop sectors had more ambitious goals of reducing trade barriers.

The USMCA agreement achieves three important objectives for U.S. agriculture:

1. **A level of certainty.** Free trade on the continent has been instrumental to growth for U.S. agriculture. The prospect of that changing injected uncertainty about the future competitiveness of the industry, which the new agreement generally resolves.
2. **Potential modest improvements in market access.** Canada's agricultural supply management system became a lynchpin in negotiations. The agreement opens the door for modest improvements in market access for U.S. poultry, eggs, dairy and wine.
3. **Success and intensified focus on China.** Reaching a deal is widely seen as a victory for the White House and creates momentum for other ongoing trade negotiations. Administration officials can also now redouble their efforts on China talks.

However, what USMCA did not accomplish is arguably as important as what it did. Specifically, it did not provide a pathway to eliminate existing retaliatory tariffs on U.S. agricultural goods. The U.S. dairy and pork industries have been hardest hit by Mexican tariffs that were implemented in July as a response to U.S. steel and aluminum tariffs imposed earlier in the year. Negotiations to eliminate the tariffs have begun, but there is no indication of how long they will remain in place.

USMCA Impacts to Agriculture

Canada and Mexico are the first and third largest export markets for U.S. agriculture, accounting for more than a quarter of all U.S. agricultural exports. *(See Exhibits 1 & 2.)* Putting those markets at risk set the industry on edge for much of 2018. Now that a NAFTA rewrite has preliminary approval, the U.S. agricultural sectors will operate with a greater degree of confidence. Investments are more likely to move forward and some level of risk has been eliminated.

However, each agricultural sector will interpret USMCA differently. To some, it is a significant step forward and to others it is akin to preservation of the status quo. The following is a brief summary of how several agricultural sectors are likely to be impacted by USMCA, by order of greatest change:

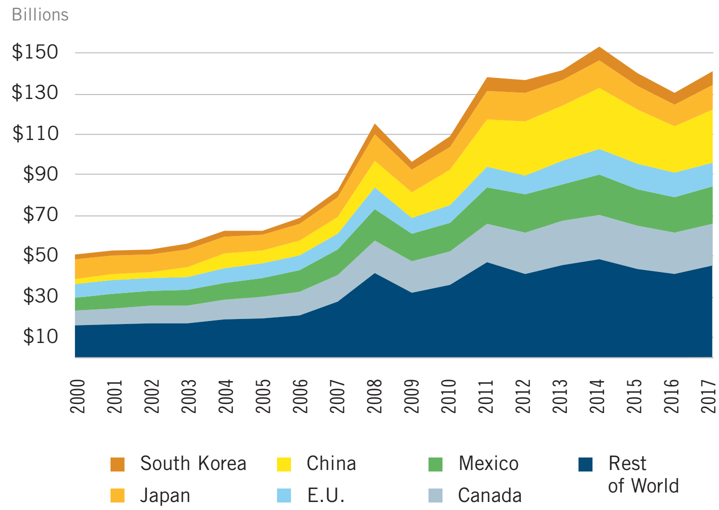
Dairy

Summary: There are many proposed changes to dairy policy under USMCA. Canada's Class 7 milk price system would be dismantled, U.S. dairy product access to Canada would increase modestly, and limits to designation of origin restrictions would be enacted. The trade pact is positive for U.S. dairy, but the gains will be limited. Mexico's retaliatory tariffs on dairy products remain, and until lifted, will far outweigh the benefits gained through USMCA.

Class 7 elimination

- The most significant change is the removal of a new class of milk pricing that Canada implemented in February 2017. The newly established "Class 7" milk price in Canada's complex pricing system acted as a non-tariff barrier by raising the floor price for milk and making U.S. ultra-filtered milk (an ingredient in some cheese making) uncompetitive in Canadian markets.

EXHIBIT 1: U.S. Agricultural Exports by Destination



Source: USDA

EXHIBIT 2: Top Trade Partners – Percentage of U.S. Ag Exports, 2015-2017

Country/Region	Share of U.S. Ag Exports
NAFTA	28.4%
China	18.3%
EU-28	8.7%
Japan	8.3%
South Korea	4.6%
TOTAL	**68.4%**

Source: USDA

- Class 7 must be eliminated within 6 months of USMCA implementation. Following that, Canada will reclassify the products and establish prices based on their end use except for skim milk powder (SMP), milk protein concentrate and infant formula.
  - U.S. ultra-filtered milk exports to Canada amounted to $102 million in 2016. To the extent that this change reopens that market opportunity for U.S. milk, the impact will be positive to U.S. dairy producers, though supply chains have already adjusted and the impact could be limited.
  - Class 7 also spurred Canadian exports of low-priced SMP. Canadian exports of SMP grew more than seven fold over the past three years. USMCA should level the playing field for SMP exports and allow the U.S. to regain some of the lost market share.

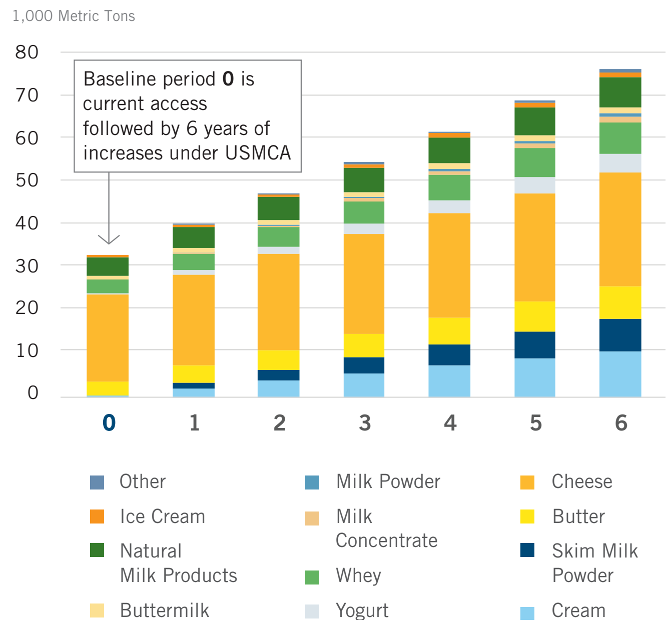
Increased market access

- Additional access up to 3.6 percent of the Canadian market will be granted to other dairy products which will be phased in over six years and will increase at a rate of 1 percent per year afterward. *(See Exhibits 3 & 4)*. Again, this is a positive in terms of access to additional markets, though growth rates and opportunities will likely be greater elsewhere in the world so this will not be a major driver of price.
  - The deal provides slightly more market access than what Canada committed to provide under TPP. However, in this case the U.S. is the sole beneficiary of those opportunities.
  - The U.S. will provide reciprocal access for imports of Canadian dairy products through first-come, first-served tariff rate quotas.

Labeling rights

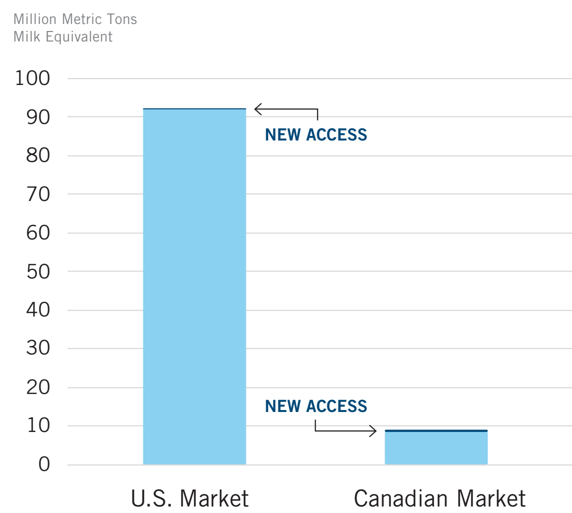
- USMCA also establishes a non-exhaustive list of commonly used cheese names that may not be restricted moving forward. Canada and Mexico

EXHIBIT 3: Increase in Canadian Market Access by U.S. Dairy Product



Source: CoBank Knowledge Exchange; USTR

EXHIBIT 4: Dairy Market Size and New Access Comparison



Source: CoBank Knowledge Exchange

have both agreed to free trade agreements with the EU, and stipulations in the agreements restrict the use of certain cheese category names such as Feta and Parmigiano Reggiano.

- The U.S. list that prevents further restrictions protects the use of terms such as mozzarella, cheddar and swiss. This is only a minor victory for U.S. dairy given that the EU labeling rules will still limit U.S. labeling options.

China and Mexico tariffs

- 25 percent Mexican tariffs on U.S. cheese and varying Chinese tariffs on U.S. dairy are still in place, pending removal of U.S. steel/aluminum tariffs. Mexico is the No. 1 export destination for U.S. cheese and represented $391 million last year.
- Cheese trade has continued despite the tariffs, but that will not continue indefinitely. If the tariffs are removed soon the market should remain intact, but a continuation would lead to an erosion of the 75 percent market share the U.S. currently holds, which could be picked up by the EU.

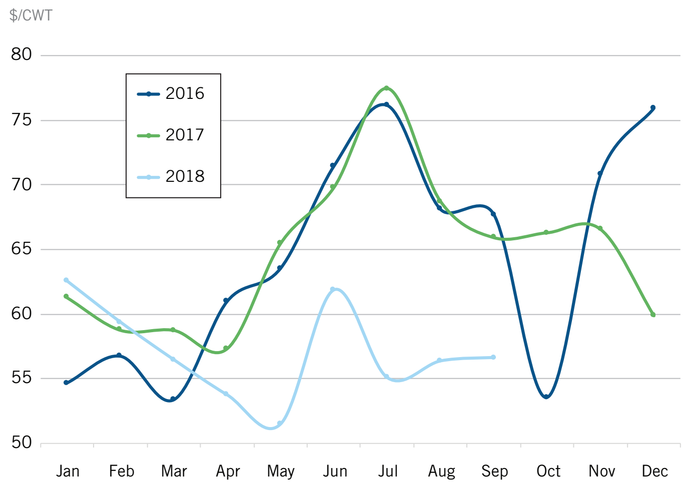
Animal Protein

Summary: The U.S. poultry and egg sectors will score modest gains in market access to the Canadian market. Pending the removal of U.S. steel and aluminum tariffs, Canadian tariffs on prepared beef products, Mexican tariffs on pork, and Chinese tariffs on all three major proteins remain in place. As U.S. red meat and poultry production continues to rise, these tariffs are the most significant impediment to trade, and less directly, industry profitability.

Exports are steady

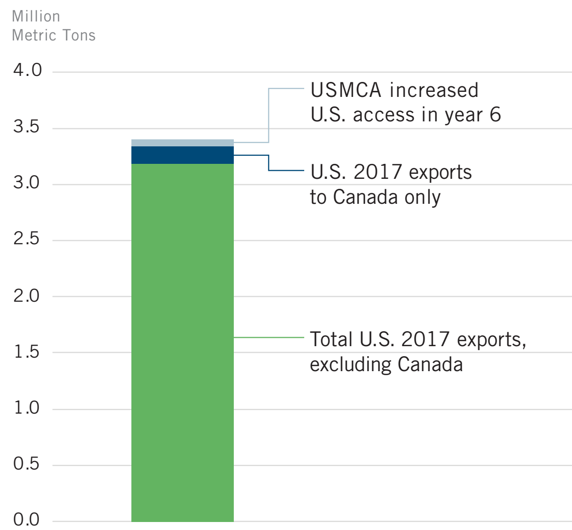
- U.S. meat export volumes to Mexico and Canada have held steady thus far in 2018, despite the retaliatory tariffs. The value of those exports have fallen substantially, however, as prices have declined in line with tariffs. *(See Exhibit 5.)* This has pressured margins, especially for the U.S. pork sector.

EXHIBIT 5: U.S. Ham Prices



Source: Livestock Marketing Information Center

EXHIBIT 6: U.S. Broiler Exports



Source: USDA; CoBank Knowledge Exchange

Increased Canadian access

- Under USMCA, the U.S. chicken sector will gain 47K metric tons in tariff-free access to Canada's poultry market in year one, and will grow to 57K tons by year six. Thereafter, access will grow by 1 percent annually for 10 years. This is a positive step for U.S. poultry, but rather small in the context of the 3 million tons of U.S. poultry exports per year. *(See Exhibit 6.)*
- The U.S. egg sector will also get additional tariff-free access to the tune of 10 million dozen eggs and egg products per year which is an increase of 15 percent from the 68.7 million dozen eggs the U.S. exported to Canada in 2017. *(See Exhibit 7.)* This tariff-free access will increase by 1 percent per annum over the next ten years.
- Trade access to Canada also increases for U.S. turkey, rising 1K tons from the 6K tons sent to Canada in 2017. This increase is small, however, in the context of the 367K tons of turkey exported by the U.S. annually.

Specialty Crops

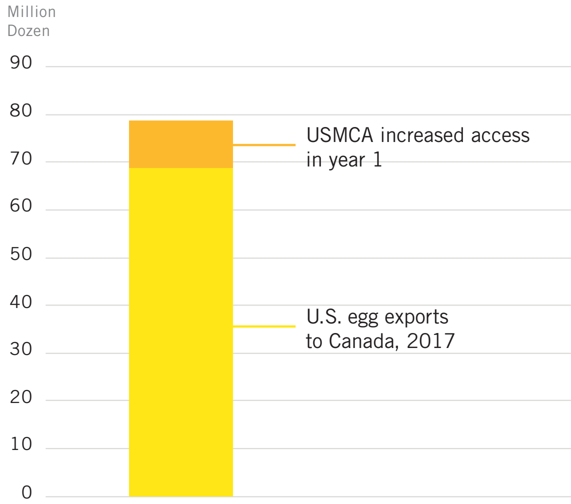
Summary: USMCA eases concerns across the specialty crops sector. Many producers and processors of vegetables, fruit and tree nuts operate across the three countries and are dependent on assets as well as demand that extends across the borders.

USMCA also eliminates a law that has permitted segregation of imported wines in British Colombia grocery stores. Under the USMCA agreement, the measures will be eliminated by Nov. 1, 2019. The Canadian market comprises 22 percent of all U.S. wine exports, second only to the European Union at 52 percent of exports. *(See Exhibit 8.)*

Grains, Biofuels and Farm Supply

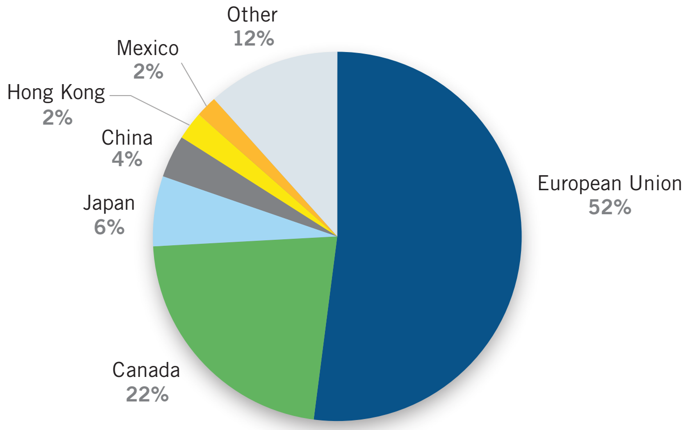
Summary: The grain, biofuel and farm supply sectors have enjoyed tariff-free trade under NAFTA, so USMCA offers continuity and risk reduction. Canada is a major buyer of U.S. biofuels and fertilizer while Mexico is the leading export market

EXHIBIT 7: U.S. Egg Exports to Canada



Source: USDA; CoBank Knowledge Exchange

EXHIBIT 8: U.S. Wine Exports by Destination, 2017



Source: U.S. Dept. of Commerce

for U.S. grains. *(See Exhibits 9 & 10.)* The U.S. also purchases a significant share of its fertilizer imports from Canada. Mexico established grain trading relationships with Brazil and Argentina in 2018, so removing incentive to further solidify those relationships is key for U.S. grain producers, processors and marketers.

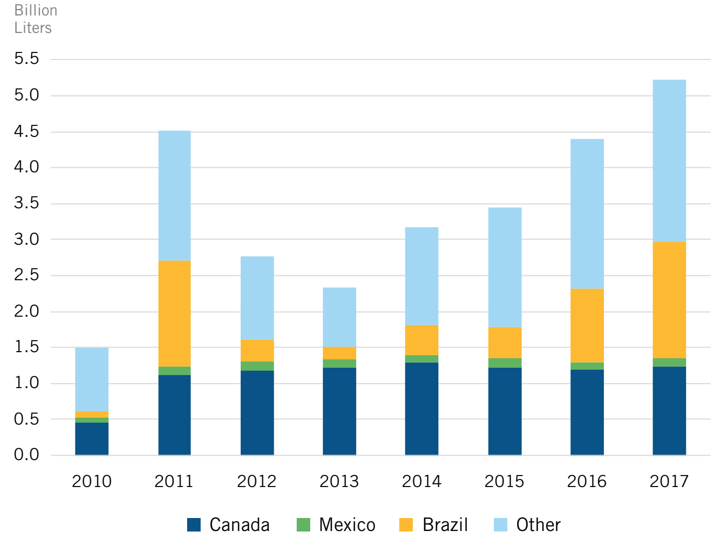
- Under current policy, any U.S. wheat exported to Canada is graded as feed wheat. USMCA requires Canada and the U.S. to grade each other's wheat as if it were produced domestically. The U.S. exports very little wheat to Canada, but this could open an additional market to U.S. wheat producers close to the Canadian border in Montana, North Dakota, and Minnesota. While a slight positive for some wheat farmers, the impact is uncertain for U.S. wheat buyers and millers in the region. If Canadian buyers show more interest in U.S. wheat, U.S. buyers will be forced to bid more aggressively for the grain.
- USMCA also mutes a Canadian grain transportation policy that supports grain exports out of Canada. This change will have little to no effect on the U.S., however, given that no Canadian grain has been shipped to the U.S. via West Coast ports in the past two years.

Cotton and Rice

Summary: Mexico is a significant buyer of U.S. cotton and rice. *(See Exhibit 11.)* While NAFTA was under threat, Mexico began entertaining rice purchases from South American exporters. USMCA should eliminate incentives for Mexico to diversify away from the U.S.

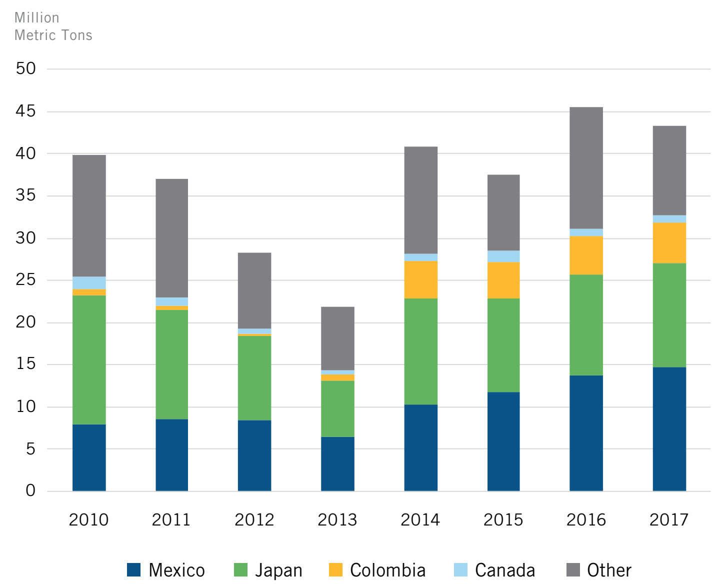
USMCA also includes a chapter on textiles and apparel that is expected to promote greater use of U.S. origin textiles and strengthen the trade between markets in North America, according to the National Cotton Council. The language in this chapter is vague, but the impact for U.S. cotton demand is expected to be modest.

EXHIBIT 9: U.S. Ethanol Exports



Source: USDA

EXHIBIT 10: U.S. Corn Exports



Source: USDA

Forest Products

Summary: The new deal preserves a trade dispute settlement mechanism that Canada fought hard to maintain to protect its lumber industry and other sectors from U.S. anti-dumping tariffs. This is a win for Canada.

Sugar and Peanuts

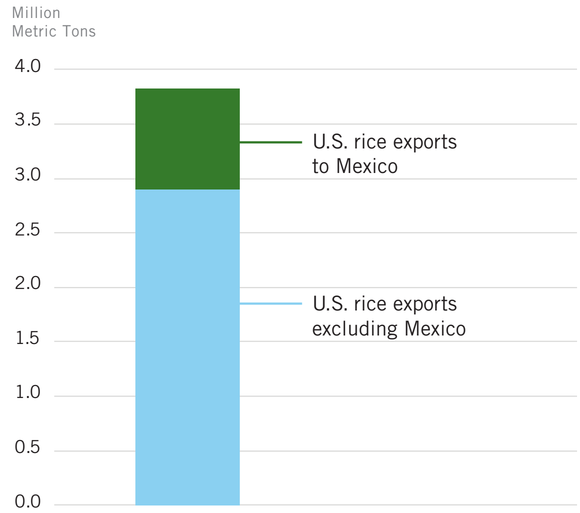
Summary: Included in USMCA is a partial opening of the protected U.S. sugar and peanut markets to Canadian exports. However, sugar beet production in Canada is de minimis, with only a few acres of beets grown in Alberta. Peanut production in Canada is effectively zero. Therefore, this policy change will have no impact.

Other Key Clauses

USMCA also contains new mandates that while not specifically focused on agriculture, will have an impact on U.S. agricultural industries:

- **Sunset clause:** USMCA will sunset in 16 years if not re-approved. Member countries will meet every six years to address concerns and revisions.
- **Exchange rates:** The new deal establishes enforceable rules to deter countries from artificially weakening exchange rates.
- **Negotiating with China:** The revised agreement requires all three countries to give 90 days' notice if they start trade negotiations with a "non-market economy," an indirect reference to China. The U.S. reserves the right to terminate USMCA with Mexico or Canada if either of them strikes a deal with a non-market economy.

EXHIBIT 11: U.S. Rice Exports, 2017



Source: USDA

The Path Forward

USMCA is likely to have little resistance gaining approval in Mexico or Canada. Both countries are expected to sign the deal before the end of 2018. The political path for ratification in the U.S. is murkier, however. The results of mid-term elections in November could determine how difficult the path will be in Congress. Democrats will not want to participate in a signature win for the White House, but there is upside for labor in the deal, which is likely to push the deal over the finish line regardless of who controls the House and the Senate. Congress may attempt to vote on the deal in the lame duck session at the end of 2018 if Republican majority is lost in the Senate or the House.

Congress will be unable to amend the text, but lawmakers will be able to shape provisions in the implementing legislation. The Trump administration is required to consult with Congress in drafting the implementing legislation. Implementing legislation could come in the form of provisions that go further than the text of the deal. This could look like additional labor protection for U.S. workers or support for U.S. industries that would be hurt by the deal.

Conclusions

In many respects, the new North America free trade pact will look very similar to the old one. It will lead to significant change in the auto industry, but changes to other industries will be marginal, including agriculture. While modest, the vast majority of impacts to agriculture will be positive. Access to the Canadian dairy and animal protein sectors will improve, and more importantly, the risk of NAFTA being dismantled will be eliminated. This will clear the way for domestic investment that is dependent on cross-border demand, as well as cross-border investment by firms that are active in two or all three of the markets.

The modest benefits that U.S. agriculture will gain from USMCA, however, will continue to be overshadowed by the remaining retaliatory tariffs imposed by Mexico and Canada. The impact of Mexico's tariffs on cheese and pork, and Canada's tariffs on prepared beef, far outweigh the benefits laid out in USMCA. Therefore, an agreement on steel and aluminum trade, whenever it is struck, will offer much more for U.S. agriculture to celebrate.

USMCA is more evolutionary than revolutionary, but it will still be a major stepping stone for the Trump Administration in its attempt to reform U.S. trade and revise free trade agreements. The White House has demonstrated that its tough negotiating tactics can lead to positive outcomes, and the compromises made by Mexico and Canada create momentum as the U.S. pivots to intensify its negotiations with China, Japan and Europe. Compromise, especially related to agriculture, will not be so easily reached with China or the EU, however, and retaliatory tariffs imposed by those two governments may last for several more months.

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