OVERVIEW

Overview

This report assesses whether action could and should be taken under World Trade Organization (WTO) rules to give local producers a ‘breathing space’ to adjust to import competition. These rules allow countries to take such ‘safeguard’ or ‘emergency’ action when a surge in imports can be shown to have caused, or threatens to cause, serious injury to the local industry. The Commission’s ‘Accelerated Report’, released on 20 December 2007, assessed the case for imposing early provisional measures pending the inquiry being completed.

The report also looks at developments in the structure and operating methods of the local industry and whether more can be done to ease cost pressures, particularly high feed grain costs.

This is the second pigmeat safeguards inquiry conducted by the Productivity Commission. The first was undertaken in 1998, when imported cuts of pigmeat from Canada began to influence local prices significantly. In that inquiry, the Commission found that a tariff of 10 per cent (phasing out over 2 years) could be justified under WTO rules.

The Commission also has undertaken general reviews of the pigmeat industry in 1995 and 2005 (the former as the Industry Commission). These inquiries were also prompted by industry concerns about the impact of import competition.

The industry has been exposed to import competition since 1990

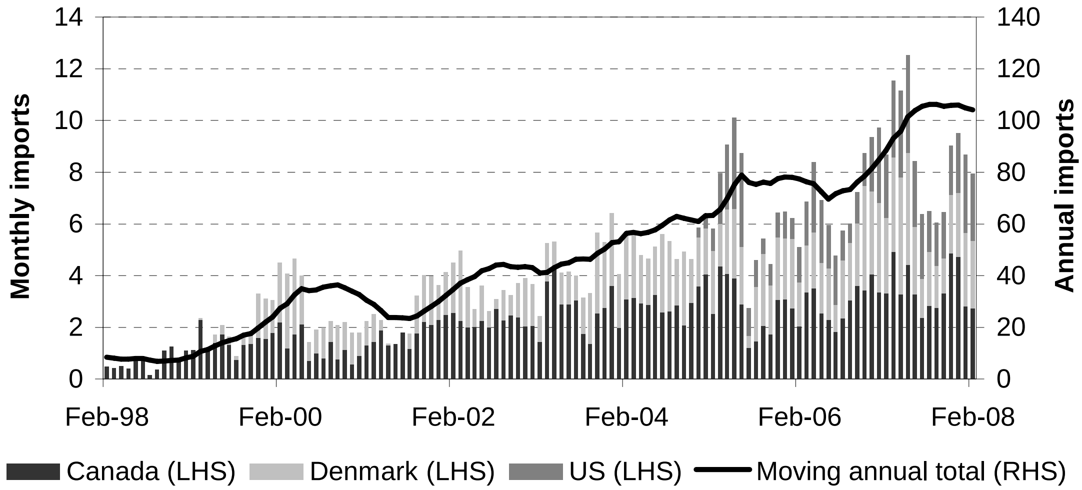
Until 1990, virtually no imports of pigmeat were permitted (except for canned hams). Since then, in line with Australia’s commitments under the Uruguay Round (in particular, the WTO Agreement on Sanitary and Phytosanitary Measures), quarantine prohibitions on the importation of pigmeat progressively have been amended to permit duty-free imports of uncooked (frozen) and cooked pigmeat from several major exporting countries.

Current quarantine protocols require frozen pigmeat imports to be boned and, on arrival in Australia, cooked to specific temperatures in approved processing facilities, to minimise the risk of disease contamination. These requirements mean that imports of cooked and uncooked pigmeat comprise boned ‘primal’ cuts such as legs, shoulders and middles, which can only be used by smallgoods manufacturers (mainly for ham and bacon). The fresh pork market, as well as smallgoods markets for 'ham-on-the-bone' and uncooked salami, continue to be supplied entirely from local production.

Imports of pigmeat have steadily increased …

Imports have increased steadily since the market was opened — first from Canada (mainly legs and shoulders for ham) in 1990, then Denmark (mainly middles for bacon) in 1997, and most recently the United States (mainly shoulders and legs) in 2004 (figure 1). By 2007, imports supplied about one-third of total domestic consumption.

Figure 1 **Import volumes have grown**
Tariff sub-heading 0203.29, kilotonnes



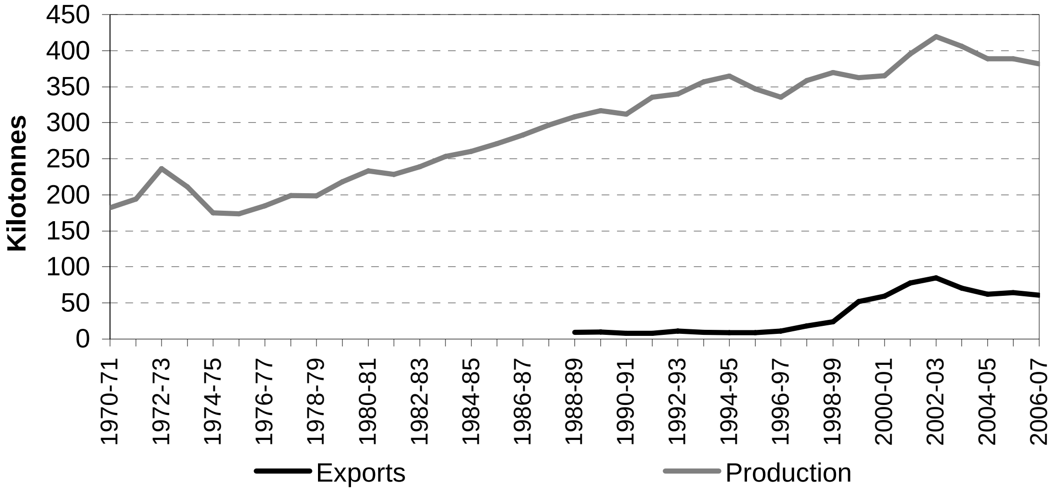
… while domestic production has been shifting to the fresh pork market

As the Commission observed in the 1998 safeguards inquiry, imports have fundamentally changed the Australian market by directly linking Australian producer prices to world pigmeat prices. Previously, the industry was fully protected from international competition, although domestic demand for fresh pork and even smallgoods was still affected by the prices of substitute meats such as beef and lamb (which are internationally traded).

That Australia is a net importer of pigmeat in part reflects cost differences. Canada, the United States and Denmark are very large producers and exporters, achieving much greater economies of scale and typically with access to cheaper and more energy-intensive feed grain than Australian producers. Despite persistent industry claims that exports to Australia are heavily subsidised, in 2005, the Commission found little evidence to support this. Pigmeat trade flows also reflect differences in tastes — Australians' preference for ham and bacon means that overseas suppliers can obtain higher prices here for some parts of the pig than they can elsewhere.

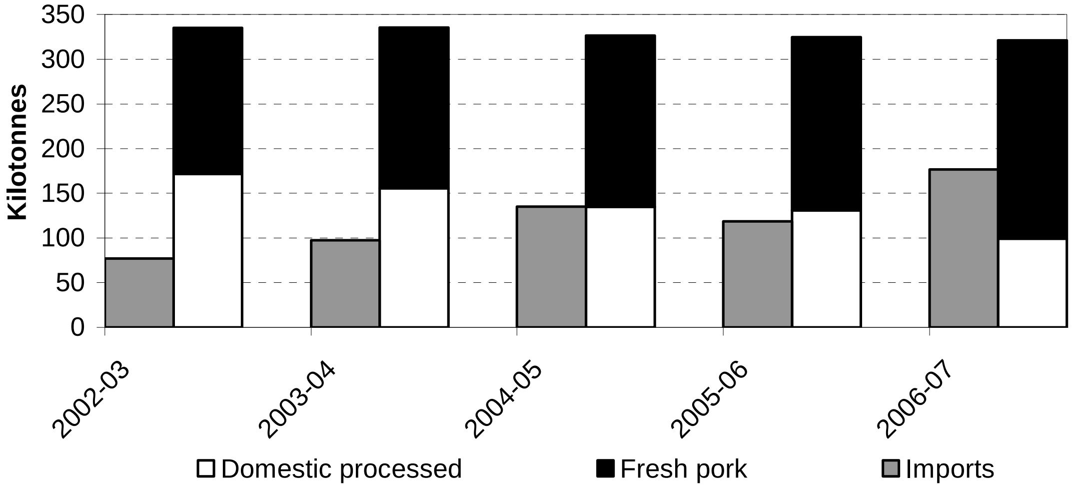
The opening of the market to imported cuts has essentially capped prices for equivalent locally-produced cuts at world prices. (Imported cuts comprise as much as 90 per cent of the value of a pig.) Import competition in the smallgoods manufacturing sector has encouraged domestic producers to switch to, and promote expansion of, the fresh pork market and, to a lesser extent, niche export markets. These expanding markets sustained steady growth in domestic production until 2002-03 — since then, a decline in exports has been mirrored in a fall in total output (figure 2).

Figure 2 **Pigmeat production and exports grew until recently**



With local producers supplying the faster-growing fresh pork market, demand for pigmeat by the smallgoods sector increasingly has been met from imports. Indeed, in recent years, with domestic output flat, imports in effect have met growth in total pigmeat consumption (figure 3).

Figure 3 **Market growth has been met from imports**



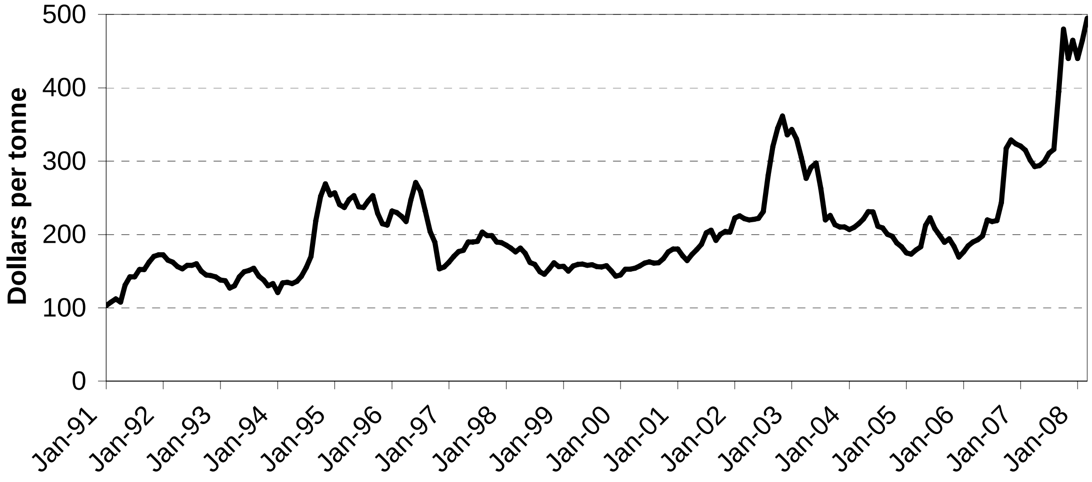
Why another safeguards inquiry?

In the second half of 2007, industry profitability slumped, with reported losses averaging around $20–$30 per pig:

- Prices for wheat and many other grains soared to unprecedented levels in mid-2007. This was a consequence of the drought in Australia and supply problems in some other countries, as well as increased world demand (reflecting world economic growth and the impact of alternative energy policies).

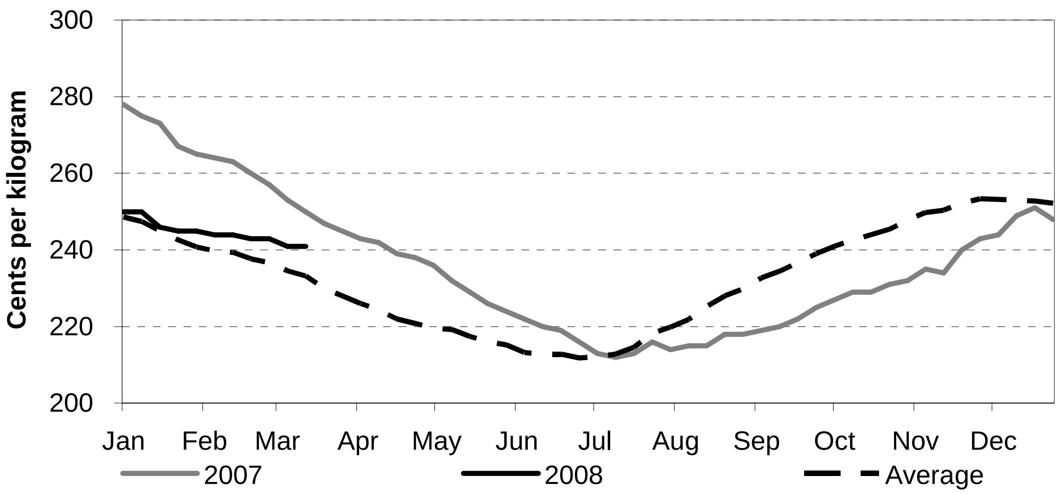
Figure 4 **Feed wheat prices surged to record highs in late 2007**

January 1991 to March 2008



- The Australian dollar also strengthened markedly against several currencies, including the US dollar and the Japanese yen, making Australian pigmeat less competitive.
- While producer prices typically rise in summer and fall in winter, reflecting sow fertility cycles and higher demand in summer months (especially for Christmas hams), for several months in the second half of 2007, domestic prices were below their average level for that time of year, and well below the historically-high levels recorded in late 2006. That said, prices were higher than average for the year overall, and remain above average in March 2008.

Figure 5 **Baconer pig prices in 2007 dipped later than usual**
3 January 2003 to 14 March 2008



Seeking respite from this cost–price squeeze, the industry argued that the significant rise in imports in the first half of 2007 compared with the previous year, established a case for safeguard action, including provisional action to reduce pressure from imports until the inquiry was completed.

The high hurdles for safeguard action

Safeguard action under the WTO is intended to act as a safety valve in exceptional circumstances, providing an opportunity for industries to adjust to increased competition from imports associated with trade concessions.

Although WTO rules do not require that increased imports have been dumped or subsidised, they impose high hurdles, *all* of which must be met before action can be taken (box 1). (There are separate provisions dealing with so-called unfair trade.)

Box 1 What is safeguard action and when can it be applied?

Safeguard action is temporary, 'emergency action' (in the form of an increased tariff, a tariff–quota or quota) taken where a surge of imports causes or threatens to cause serious injury to a domestic industry.

1. The domestic industry must comprise at least a majority of producers of products like or directly competitive with imports.
2. Imports must have increased in absolute terms or relative to domestic production. The increase in imports must be the result of unexpected and unforeseen developments and be 'recent enough, sudden enough, sharp enough and significant enough'.
3. The industry must be suffering serious injury or such injury must be threatened. While not explicitly defined, 'serious' injury sets a higher threshold than 'material' injury. Factors such as changes in market share, sales, production, productivity, capacity utilisation, profits and losses and employment must be assessed.
4. Increased imports must be shown to have caused, or threaten to cause, serious injury. The impact of other factors must be separately identified and assessed.

Safeguard measures normally can apply for up to four years (including any provisional measures), and possibly up to eight years. Measures can only be applied to the extent necessary to prevent or remedy serious injury caused by increased imports and to facilitate adjustment.

These hurdles include properly identifying the goods in question and the producers comprising the domestic industry, confirming that imports have increased, demonstrating serious injury and establishing a causal link between increased imports and such injury.

Some additional hurdles apply because of undertakings Australia has made in bilateral preferential trade agreements. Of special relevance is the Australia–United States Free Trade Agreement, under which Australia *may* exclude imports from the United States from general safeguard action 'if they are found not to be a "substantial cause" of serious injury, or threat thereof'.

While the Agreement on Safeguards requires that that all interested parties be given an opportunity to present their views 'as to whether or not the application of the safeguard measure would be in the public interest', the criteria focus on the impact of imports on local producers. The Terms of Reference for this inquiry (reflecting gazetted Australian Government requirements) go further, requiring the Commission to subject any proposed safeguard measures to an assessment of the wider costs and benefits, including for consumers.

Have the hurdles been met?

In its Accelerated Report, the Commission found that most of the WTO hurdles had been met, but it could not substantiate a case for provisional safeguard measures. Preliminary analysis pointed to an unprecedented increase in feed grain prices, rather than increased imports, being the cause of the cost-price squeeze hurting pig producers and, indirectly, pigmeat processors.

Foreign exporters and their governments argued against those findings supporting particular safeguard criteria, but supported the negative finding on causation. Domestic producers argued the opposite.

The Commission reviewed and developed its analysis in the light of comments received on the Accelerated Report. But its earlier conclusions have been broadly affirmed: while there is clear evidence that imports have increased and that the domestic industry is suffering serious injury, higher feed costs, not increased imports, are the cause.

- The Commission did not accept legalistic interpretations advocated by some parties. For example, exporting countries argued for exclusion of pig producers from the 'industry' as defined for safeguard purposes. Defining an industry is never easy, but to exclude producers of the dominant ingredient in processed pigmeat makes little economic sense. Because of the ownership and structure of the local pigmeat industry, it makes little legal sense either.
- The Commission has also affirmed its conclusion that imports have increased significantly. On balance, it also considers that the sharp increase in import volumes in the first half of 2007 — arising from higher prices (reflecting worldwide supply shortages in 2006) and forward-buying by manufacturers — was not foreseeable.
- Although the Commission was criticised by exporting countries for not providing sufficient evidence to support its finding of serious injury, it has confirmed its preliminary assessment on this matter too. In doing so, it has applied standards of evidence routinely applied by other countries in WTO investigations. That said, the recovery in prices during the course of the inquiry (the normal 'Christmas' premium), and falling prices of sorghum following summer rains, have helped to improve producer profitability, or at least to reduce losses.

A link between increased imports and serious injury has not been established

The domestic industry argued that the Commission's reasoning on causation in the accelerated report was flawed for two main reasons:

- increased imports had caused serious injury because the high level of imports recorded early in 2007 had prevented domestic producer prices from rising in line with higher domestic costs, and had driven prices down to below average in the latter part of 2007, and
- imports must be either dumped or subsidised, because import prices had not risen in response to higher world prices for feed grains.

Australian Pork Limited (APL) asserted that if the Commission had followed the logic of its 1998 report, it would have found safeguard action warranted. But this assertion is not well founded. Indeed, the Commission has followed the same approach and applied the same 'model' of the industry as in 1998. The different conclusion in this report reflects different facts.

In 1998, following easing of quarantine requirements, cheaper imports had started to enter at levels that affected domestic price levels, with domestic producer prices falling to exceptionally low levels (in retrospect, the lowest recorded for nearly 20 years). Analysis showed that no other factors could adequately explain the price fall and the loss in industry profitability — feed costs were moderate and exchange rates favourable — although the Commission did note that a small part of the price fall was attributable to increased domestic production.

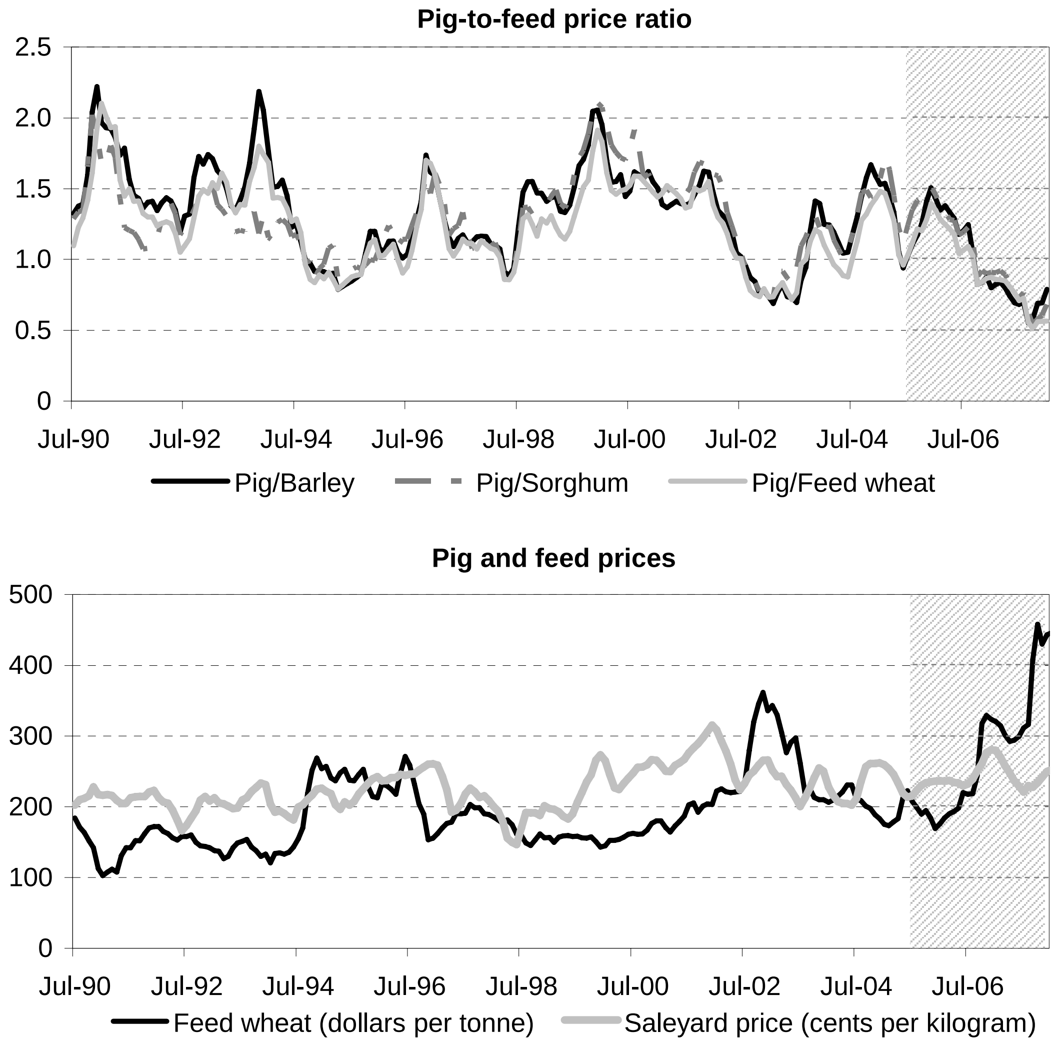
High feed costs are the problem this time

In contrast, analysis undertaken for this investigation clearly shows that higher feed costs have been the dominant cause of the recent and sudden decline in industry profitability. Without increases in feed prices, which have added around 70–80 cents per kilo to production costs since early 2006, domestic producers would not have sustained serious injury in 2007.

- As shown in figure 6, feed prices began to rise in the second half of 2006, adding about 30 cents per kilo to domestic costs. However, the impact was cushioned somewhat by unusually high prices at that time, caused by a shortage of pigmeat.
- In the second half of 2007, feed prices rose further, adding an additional 40 to 50 cents per kilo to costs. This cost increase coincided with a recovery in world pigmeat supplies and a return to close-to-average prices. The only difference was a short delay in the normal winter price trough. This delay brought prices higher than average in the first half of 2007 and a little below average in the second

half, but about 4 per cent higher than average for the full calendar year. In March 2008, contract prices for baconer pigs (which account for about 80 per cent of sales) were a little *above* their 5-year seasonal average.

Figure 6 **The pig-feed price ratio has plummeted**



Price 'capping' does not establish causation

It goes without saying that if pigmeat prices had been higher, injury caused by higher feed costs would have been moderated. Nonetheless, even without imports, the price sensitivity of consumers, given domestic availability of substitute meats, would limit the scope to pass on higher costs. Indeed, Commission modelling suggests that producer prices would rise by only around one-quarter of the full amount of any cost increases (box 2).

It also goes without saying that lower levels of imports, *all else constant*, would lead to higher prices (as was the case in 2006). But acknowledging that fewer imports *could* provide price relief is different from saying that increased imports have been a cause of serious injury. Empirical observation, as well as economic and econometric analysis, provide strong grounds for concluding that imports have risen to meet demand in the processed pork market as domestic supplies have shifted to the fresh pork market, with prices generally tracking close to average levels.

Box 2 **Econometric evidence that imports have pushed down prices and production is lacking**

The Commission undertook econometric modelling to help shed light on the issue of causation. While such modelling has limitations and is not definitive, the more robust results suggested that:

- import volumes have had only a very small (often statistically insignificant) adverse effect on prices
- increased imports have not reduced domestic production
- import prices, not volumes, have exerted the main influence on domestic prices
- higher feed prices have hurt the industry because producers are unable to pass them on fully, with or without imports.

That world pigmeat prices have not yet risen to reflect higher world grain prices is not surprising. Barring other 'shocks' or policy interventions, this will occur only as world production is cut back to restore industry profitability. As in Australia, world pig production cannot be cut back instantaneously when costs rise relative to prices received. Moreover, as the Commission observed in the Accelerated Report, domestic feed grain prices appear to have risen much more than prices for foreign producers, reflecting the Australian industry's reliance on wheat. And while the Commission is critical of the European Union's decision in late 2007 to introduce export subsidies on some cuts of pigmeat, there is no evidence that prices of Danish middles exported to Australia have been affected.

Improving industry competitiveness

As for most other Australian industries, import competition is now a fact of life for the pigmeat industry. Many in the industry, while accepting this in principle, argued that temporary protection was needed to give producers time to put in place measures to improve competitiveness. However, the history of this industry and many others suggests that competition spurs more innovations and efficiencies than it impedes.

The pig growing section of the industry has undergone significant rationalisation and structural change over time. Currently there are fewer than 1900 pig producers, compared with around 7000 just 20 years ago. Producers also have adopted new technologies and operating methods, including improved risk management techniques, to improve productivity and product quality.

The primary processing part of the industry has also rationalised, with a number of plant closures leading to increasing concentration and specialisation. The top 20 abattoirs currently account for about 95 per cent of pigmeat.

The industry largely accepts the need for further rationalisation and efficiency improvement and has several strategies underway to do this, some in conjunction with government. However, as the Commission observed in its 2005 report, many programs (including those funded by the pig slaughter levy and matching government funds) are not routinely and independently monitored or evaluated.

Some regulations also appear to impose unnecessary burdens, or have unintended effects. For example, labelling laws requiring identification of imported products can unintentionally catch local pigmeat seasoned with brine containing imported chemicals. The industry's strategy of moving away from generic county-of-origin labelling and to 'brand' local pork seems to be a step in the right direction. Proper regulatory assessment and review processes should also be applied by government.

What can be done about higher feed costs?

Feed accounts for almost 60 per cent of the costs of producing a pig. Grains account for around 80 per cent of feed costs. The industry, through a variety of channels, including the innovative work of the joint government and industry funded Pork Cooperative Research Centre (CRC), is attempting to improve feed conversion ratios and feed efficiency.

Feed grain *prices* are another matter. Recent rises are in part attributable to drought, economic growth and changing tastes. But they also reflect impacts of quarantine restrictions on grain imports (especially during drought) and of ethanol policies overseas and, to a lesser extent, in Australia.

While the Australian Government cannot alter policies of foreign governments, it can use international forums to highlight the undesirable and unintended impacts of such policies. In Australia, a review of the wider impact of current and proposed domestic policies is urgently needed to determine the best way forward for ethanol policy, taking into account the impact on consumers and other industries, including grain users.

Some final observations on safeguards and industry assistance

Australian pigmeat producers, along with their foreign counterparts, are feeling the pressure of high feed grain prices. In the Commission's assessment, these cost pressures do not pass the test for safeguard protection against imports. To conclude otherwise would be to subvert the intent of safeguard action and to open the door to import protection being based on domestic cost disability.

The Commission is concerned that in this and other areas of the Agreement on Safeguards, creeping legalisms are undermining the proper role for safeguard provisions within a liberal trading order. If the Agreement is to continue to play a useful role, and avert a return to 'grey area' remedies, these developments will need to be addressed by WTO members.

The pigmeat industry is also seeking additional financial assistance of at least $80 million, equivalent to almost 10 per cent of its farm value added. This is intended not only to help those leaving the industry, but also those who have already left and, indeed, those staying. Many agricultural industries are facing a similar cost-price squeeze and other hardships, and it is not evident why pigmeat producers and processors should receive such special treatment. The industry already receives at least $7 million annually from the Australian Government for research and development, as well as around $3 million via drought relief and other programs. State Governments also provide support. Moreover, almost half the industry's domestic market remains immune from import competition.

In the Commission's assessment, further assistance is difficult to justify. Many Australian industries today face more intense international competition than in the past. Such industries have generally done best where they have focused their efforts on being more innovative and efficient, rather than seeking government support.

At the very least, the effectiveness of current government-funded programs should be evaluated before further assistance were contemplated, and any proposed new measures would need to be shown to be of net benefit to the Australian community, not just industry interests.