be accompanied by changes to its domestic supply control program, does not guarantee continued higher U.S. exports. Without supply control, Canadian production would increase and milk prices would decline, affecting imports.

Given regional cost differences in the two countries, there would likely be higher dairy trade in the long run between the two countries in the absence of border protection. But net trade may not change dramatically as east-west flows of dairy products across each country are replaced by north-south flows across the border.

The natural trading flow without political boundaries would be south to north. The Pacific Northwest is a good example, with the cost of dairy production lower in Washington State than in British Columbia. Dairy products from Washington would have a location cost advantage due to lower transportation costs compared with eastern Canada. In other regions, such as the northeastern U.S. where variable costs of production are high, (as are those in Ontario and Quebec), reduced trade barriers could result in increased trade from eastern Canada to the northeastern U.S. for some products.

Canada is making some adjustments to improve processing industry competitiveness, such as providing inputs at competitive prices. If the dairy industries of both countries became more efficient as a result of a more open North American border and changes in domestic policies, there would be less need for border protection with other countries. But as long as the dairy sectors remain highly supported, border protection is a necessary complement to domestic policies.

Most economic research on dairy policies has focused on U.S. and Canadian producers, especially those that would face an extremely competitive situation without existing policies. However, the clear winners of increased trade between the countries would be consumers in both countries, who would pay lower prices. *[Suchada Langley (202) 219-0006, Richard Stillman (202) 219- 0844, and Leanne Hogie (202) 720-1314; slangley@econ.ag.gov; stillman@econ.ag.gov; hogie@fas.usda.gov]* **AO**

Argentina & Brazil: Key Players in New Trade Bloc

The agricultural economies of Argentina and Brazil are becoming more efficient and are likely to remain challenging competitors in the global agricultural market. Domestic reforms in the past few years, such as reducing and eliminating export taxes on agricultural products and reducing import taxes on farm inputs, are increasing production efficiency.

In addition, the new Southern's Common Market—known as MERCOSUR—has eliminated most tariffs on products traded among its members (Argentina, Brazil, Uruguay, and Paraguay). This regional liberalization of trade is solidifying gains from domestic policy reforms. Together these developments, along with relatively buoyant farm prices, are boosting prospects for increasingly competitive agriculture industries in Argentina and Brazil.

Morever, the economic climate has generated more foreign direct investment in both Brazil and Argentina's food and agricultural sectors. The free flow of most goods within MERCOSUR has created powerful incentives for firms to base production facilities locally from which to supply the region.

MERCOSUR is providing a springboard to further economic integration with other countries in the region and the world. The recent inclusion of Chile in a free trade agreement with MERCOSUR is the latest chapter in the fast-moving drama of regional integration. Trade agreements are on the horizon with other countries in the Western Hemisphere and the European Union. At the Summit of the Americas held 2 years ago in Miami, for example, all the Western Hemisphere's democratically elected leaders agreed to set up a Free Trade Area of the Americas by the year 2005.

MERCOSUR Eliminates Most Internal Tariffs

Trade between MERCOSUR's largest members has blossomed to record levels following elimination of most internal tariffs. Total bilateral trade between Argentina and Brazil mushroomed to $9.7 billion in 1995, up almost fivefold in 5 years.

Argentina's total exports to Brazil climbed significantly to $5.5 billion in 1995, almost four times the 1990 level. Agricultural exports, primarily wheat, dairy products, corn, deciduous fruit, and rice, accounted for nearly 40 percent of Argentina's total exports to Brazil in 1995. Brazil's total exports to Argentina for 1995 likewise rose to $4.2 billion, over five times the level of 1990. Agricultural exports account for under 10 percent of Brazil's total exports to Argentina, with coffee and sugar the major items traded last year.

The establishment of MERCOSUR in January 1995 signaled the end of an era of inward-looking policies. The agreement was the culmination of a process started in the late 1980's when both Argentina and Brazil began to open their economies and moved away from import substitution and development-at-any-cost policies.

Negotiations aimed at reaching full common market status by the year 2000—with labor and capital also flowing freely—continue. However, to reach full common market status, the coordination of at least labor and capital policies—certainly still an ambitious task—must be achieved in addition to tariff elimination. MERCOSUR's size and its potential for growth give it considerable stature during future international trade negotiations.

The current MERCOSUR agreement dismantles most intra-regional tariffs, harmonizes internal tariff codes, and provides procedures to eliminate nontariff barriers. About 80 percent of all products traded now have duty-free status within the bloc. The agreement also establishes a common external tariff (CET) that applies to imports from third countries. The average CET of MERCOSUR is estimated at 14 percent, with a range from 0 to 20 percent. For agricultural products, the range is also from 0 to 20 percent, but with an average estimated at about 10 percent. The CET's are generally lower than most import duties they replaced.

Exceptions to trade liberalization are stipulated in the agreement for economic sectors where levels of protection and support are high—negotiations were basically postponed. The only agricultural sector exempted is sugar. Most exceptions will be phased out in the next few years.

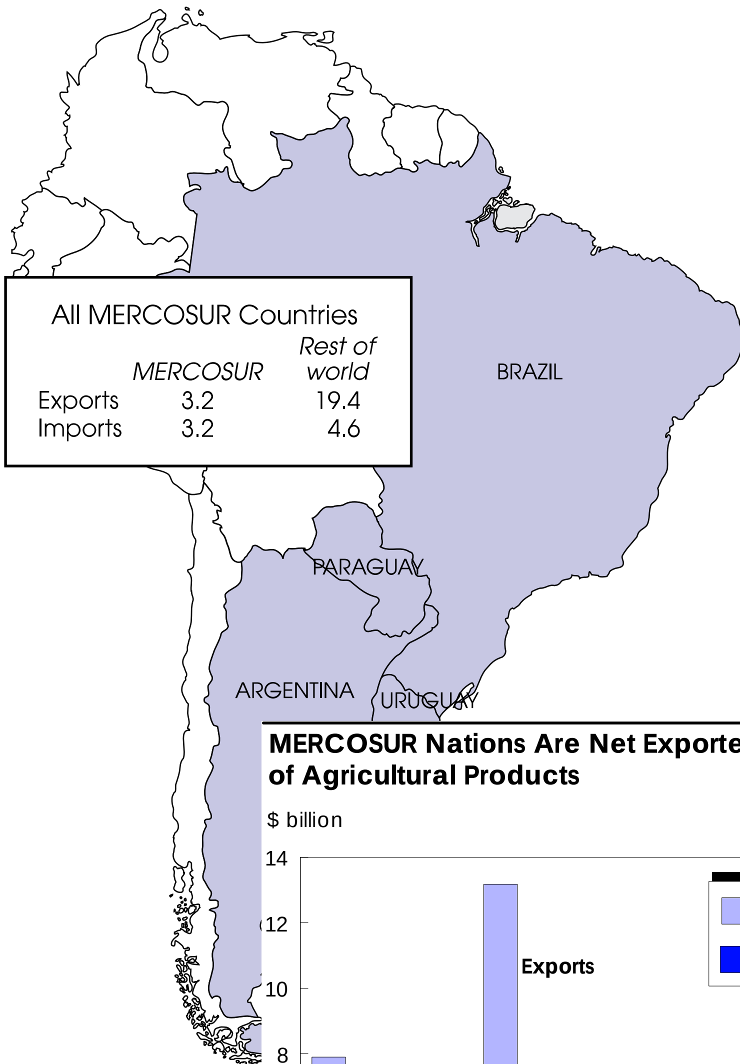
Trade Bloc Should Spur Ag Specialization

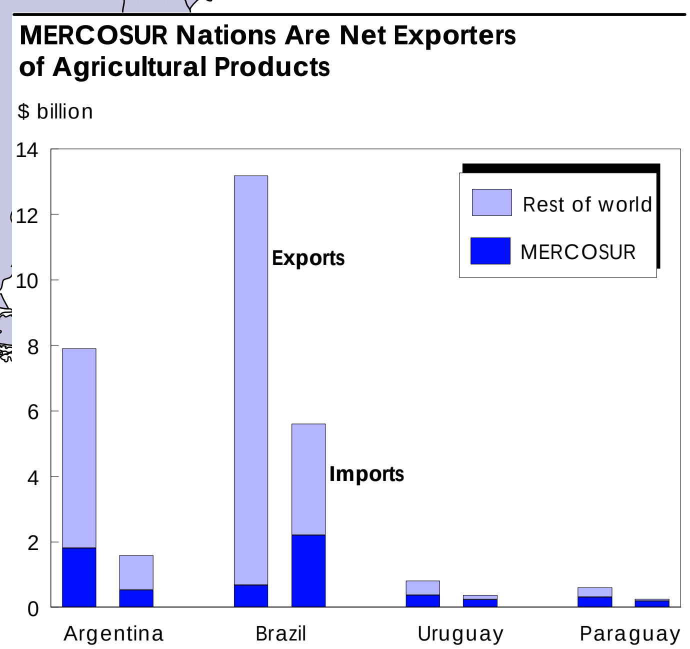
Argentina has traditionally been a low-cost producer of grains, oilseeds, and other temperate climate products. The country is endowed with a large amount of fertile cropland, situated mostly in the central east portion of the country known as the pampas. Most of this cropland is rotated to varying degrees with pasture land for cattle.

Since implementation of MERCOSUR, Argentina has increased its exports of most temperate climate commodities, particularly grains (wheat, corn, rice, and barley), dairy products, cotton, deciduous fruit, and vegetables, all of which have a cost advantage over their Brazilian counterparts. Because Brazilian producers of these commodities were largely shielded from international markets through tariffs and government support measures in the past, these commodities are expected to decline in relative importance under MERCOSUR. The possible exceptions are corn and dairy, all of which have recently shown productivity gains. But growth in Brazil's corn consumption is expected to absorb domestic increases in corn production.

Soybean production—already internationally competitive in both countries prior to MERCOSUR—should not be significantly affected in Argentina. In Brazil, soybeans could displace some of the previously supported crops, notably cotton and rice.

MERCOSUR Nations Are Net Exporters of Agricultural Products





MERCOSUR is expected to strengthen already important agricultural trade patterns between member countries for some commodities. For example, intra-trade of wheat and other grains accounts for about 65 and 75 percent, respectively, of the total trade of these commodities. An expected effect is that Argentina will supply a larger share of Brazils grain import needs.

The likely effects of MERCOSUR on intra-MERCOSUR beef trade is less clear. Beef production in Argentina and Brazil is internationally competitive, with both countries shipping beef to third countries, including processed beef to the U.S.

Brazil has the world's largest commercial cattle herd, but the country occasionally imports beef from Argentina, mostly in the winter months when Brazilian production drops below consumption levels. Brazil's per capita beef consumption is about half of Argentina's and is sensitive to income growth. With free trade and with increased stability and growth, Brazilian imports could rise. However, greater stability is also likely to promote greater beef production in Brazil.

Brazil has a dynamic and competitive poultry industry and is a major player in world markets. As tariffs have declined, Brazil has supplied more poultry to Argentina. Although Argentina's poultry industry has increased productivity in recent years, the sector is still considered to have slightly higher costs than Brazil's (particularly for electricity, fuel, and labor). This could change in the future as both countries strive to streamline their economies.

Brazil is one of the world's largest sugar producers (production is projected at a record 14.5 million tons in 1996/97), with output about 10 times greater than Argentina's. Brazil's production costs are lower than Argentina's, despite substantial deregulation of Argentina's sugar industry in recent years. The largest portion of Brazil's huge sugarcane output goes to a fuel alcohol program. Even though sugar was excluded from the MERCOSUR agreement, Argentina purchased Brazilian sugar last year as the result of a domestic shortfall, and could do so in the future. Both countries export sugar to the U.S. within a mixed quota and tariff-rate quota system.

Argentina Pursues Free-Market Ag Policies

The performance of Argentina's agricultural sector was out of step with the general economy from 1991 to 1994. Following reforms to stamp out inflation, deregulate the economy, and privatize many state-owned enterprises, most sectors boomed during 1991-94 while the agriculture sector suffered. Low international grain prices, combined with tying the domestic currency to the dollar and declining but still relatively high inflation, put export-dependent farmers in a cost-price squeeze. High taxation levels added to the burden, and agricultural production stagnated.

But rising commodity prices since 1995, coupled with previous policy reform, have boosted agricultural prospects. Meanwhile, Mexico's peso crisis in late 1994 helped put Argentina's overall economy into a tailspin, as foreign capital became reluctant to invest in Latin America.

Argentine agriculture stands to gain from the combination of higher world grain prices, increased regional integration, and the maintenance of a more neutral farm policy. In the past, periods of high prices were almost invariably followed by increases in export taxes or other tools to extract a proportionate segment from farm incomes.

Record Field Crop Output Ahead

Farmers in Argentina and Brazil, responding to higher world prices, have increased plantings of wheat, corn, and soybeans in 1996/97. With a return of normal rainfall after last year's drought, crop yields are also generally expected to be higher. As a result, record grain and oilseed output is expected.

In Argentina, higher returns for field crops than for livestock altered rotational patterns, pushing fallow and pasture land into crop production. Total grain and oilseed area is estimated at a record 20.5 million hectares, compared with the previous record of 18.7 in 1983. Average yields for most crops are also expected to be up, and wheat, corn, and soybean production are expected to reach record levels. World wheat and corn prices have come under pressure this marketing year, partly in anticipation of large Argentine crops.

Argentina is traditionally one of the world's leading exporters of wheat, usually trailing only the U.S., the European Union, Canada, and Australia in volume exported. In 1996/97 (December-November), Argentina is projected to harvest a record 15.5 million tons of wheat. Argentina's wheat exports are projected at a record 11 million tons, boosted by the large supplies and competitive pricing.

Area planted to wheat in Brazil is also up sharply from last year's very low levels, and combined with higher yields, output is expected to double. Even so, wheat is less competitive than Brazil's other sectors, and resources are expected to continue to leave it in favor of more lucrative outlets. In 1996/97, Brazil is expected to remain a major wheat importer.

Although Argentina's corn crop is typically about one-third the size of Brazil's, the country is considered a major player in the world market, normally exporting slightly over half of its crop and accounting for about 10 percent of world exports. Argentine corn output is expected to be up 19 percent over last year, setting a new record. Most of the production increase is due to higher acreage, but yields have also registered impressive gains over the last few years, largely a result of greater fertilizer use. Brazil will continue to be a major corn importer. However, its corn production is also projected up sharply—second largest ever—on the strength of expanded acreage.

Brazil is the world's second-largest soybean producer and exporter after the U.S. Strong soybean prices earlier this season are expected to result in an 11-percent increase in area planted to soybeans. Part of the increase is on double-cropped wheat acreage, which could curtail yield increases. Brazilian soybean output is expected to be a record 26 million tons, up 10 percent from last year. Argentine soybean output is also forecast to hit a record 13 million tons, up 7 percent from last year, due to higher yields on record acreage.

By adopting a more free-market approach in the 1990's, Argentina has gone a long way toward reforming policies that damaged the agricultural sector by directing resources away from it. Export taxes on most agricultural products have been eliminated (exports of bovine raw hides and oilseeds are still taxed to favor local processing). The major state-owned marketing boards for grains, meats, and sugar have been scrapped, and privatization of export facilities has reduced port handling costs. The port at Buenos Aires, previously considered one of the world's most inefficient, is now a model for the region. Privatization of railroads has also begun to curtail high domestic transportation costs.

Import duties for most agricultural products and inputs have been reduced and are well under the 35-percent ceiling agreed to by Argentina in the Uruguay Round. Imports of fertilizers, pesticides, machinery, and irrigation equipment are at all-time highs, in part favored by a more import-friendly atmosphere. Argentina still imposes a 3-percent tax on imports from all non-MERCOSUR countries.

In the past, low adoption of inputs and technology was explained largely by chronic economic instability and by policies biased against agriculture. Greater use of inputs—mostly fertilizer for wheat and corn, irrigation for corn, and herbicides for field crops in general—has been boosting yields in recent years. No-till and minimum-till technologies, which generally reduce production costs and can raise yields, have been increasingly adopted. Greater use of hybrid seed (corn and sunflowers) and of new varieties (soybeans and wheat, including herbicide-resistant soybeans) reinforces this surge in technology adoption.

Many farmers are still strapped financially, with interest rates on farm loans prohibitively high. The growing use of planting "pools" is a response to the economic upheaval brought about by policy reform. Under sharecropping and leasing arrangements, land is farmed by professionals with the necessary technical expertise, while capital is supplied by investors. Some of this capital comes from recently privatized pension funds seeking profitable investment opportunities.

Prospects for Argentina's cattle sector are also likely to improve. Negotiations with the U.S. during the Uruguay Round of the GATT resulted in a Memorandum of Understanding for the U.S. to import 20,000 metric tons of fresh beef per year from Argentina, once Argentina is declared free of foot-and-mouth disease (FMD). In addition, USDA's Animal and Plant Health Inspection Service recently proposed new criteria for imports of animals or animal products into the U.S. based on scientific risk assessments, which, if adopted, increase the possibility of fresh beef imports from Argentina.

Argentina has successfully implemented an FMD vaccination program, with no outbreaks reported in over 2 years. Resolving Argentina's sanitary status regarding FMD for the U.S. market will open the door for greater fresh beef exports to more markets, including the fast-growing Asian markets led by Japan and Korea.

Argentine beef exports are affected by lack of adequate international marketing and promotion activities. This is due partly to its current sanitary status regarding FMD. In addition, tax evasion and marketing inefficiencies in the large domestic beef sector have discouraged investment in the export processing sector, which is subject to greater tax and sanitary controls.

Brazil's Reforms Promote Ag Efficiency

Brazil's farm policy reforms have come a few years later than in Argentina. But the goals have been similar—to bring domestic prices more in line with world prices, which would redirect resources from less competitive ag subsectors (e.g., wheat) to more efficient ones (e.g., soybeans). As in Argentina, government intervention is less pervasive now, but the transition to open markets has been more gradual, particularly for policies aimed at cushioning adverse impacts on small landowners.

Brazil is in the midst of an economic stabilization program, which originated in mid-1994 and is known as the "Real Plan" (named after the new currency, the *real*). The program has successfully tamed inflation—in June of 1994, inflation had reached 50 percent per month, but recently has been below 2 percent per month.

Brazil's current challenges are to maintain the more open, lower inflation environment while striving for the strong economic growth required to absorb an expanding labor force. However, Brazil continues to face pressure from different lobbying interests, including some in agriculture, to reverse the reform process.

The tight money supply, which resulted from the Real Plan, has had a significant impact on Brazilian farmers by sharply increasing their costs of borrowing. Although inflation is no longer a serious problem, the majority of Brazilian farmers are heavily indebted, and high real interest rates boost production costs. Farm credit from the federal government is declining, which is limiting access to credit for the more than 60 percent of Brazilian farmers who need loans for production inputs. Banks are encouraged to seek low interest rates overseas to increase lending to agribusiness.

The Brazilian government no longer provides a price safety net. Exceptions may apply to small farmers. Under the revised Federal Government Loan Program, small farmers are still eligible for marketing loans, which may be repaid by selling the crop to the government at an established support price. However, most farmers no longer have this option and therefore will have to base their production decisions on market prices. As a consequence, they must either become more productive or switch to other crops. Production of rice and wheat is expected to decline, with some farmers shifting production to soybeans. Thus, the U.S. soybean industry may face tougher competition from Brazil.

The most significant development for Brazilian farmers since implementation of the Real Plan is Law 87. It provides for elimination of a state tax (referred to as ICMS, or Imposto sobre Circulacao de Mercadorias e Servicos) on primary and semiprocessed agricultural exports. The

ICMS tax on exports varied from 5 to 13 percent, depending on state and commodity. It was a major component of what is dubbed the "Brazil Cost," exemplifying the difficulty Brazilian agriculture faces when competing in world markets.

The agricultural export sector in Brazil has been handicapped by being taxed, while value-added industries in general (e.g., textile, shoe, and automotive industries) have been highly protected regardless of their international competitiveness. The elimination of the tax, equivalent to a 5-percent devaluation of the real, should provide immediate benefit to farmers producing commodities for export by lowering the cost and boosting demand from foreign buyers.

Marketing boards for wheat and sugar have been abolished, and government purchasing and marketing activities have been privatized. The only such agency that remains, the Cocoa Institute, has become a farm extension agency helping cocoa producers adopt new technology and improve their management techniques.

MERCOSUR's Impact on U.S. Ag Exports Is Mixed

U.S. agricultural exports to MERCOSUR are expected to remain small compared with exports to Asia or Canada, as MERCOSUR continues to be a net agricultural exporter. U.S. agricultural exports to Brazil in 1995 totaled $490 million, about the same as in 1994. Although Brazil is the third-largest Western Hemisphere market for U.S. agricultural exports, it is dwarfed by the largest U.S. market, Japan (almost $11 billion) and by Mexico ($3.5 billion). U.S. agricultural exports to Argentina last year totaled $126 million.

U.S. exports of bulk agricultural goods to the region, such as wheat and rice, had declined even before the implementation of MERCOSUR, replaced mostly by increased Argentine competition. But the stabilization and greater growth fostered in part by MERCOSUR has helped to boost sales of other U.S. products to the region.

A case in point is processed food products, for which there is a growing demand in both Brazil and Argentina. In addition, U.S. products have better promotion, packaging, and distribution systems compared with their South American competition. Exports of U.S. processed food products to Argentina during 1995 totaled almost $60 million, 10 percent higher than the previous year despite a local recession. The leading food category was snack foods. Recent U.S. food promotion activities in both Brazil and Argentina were successful and should help further sales.

With unilateral agricultural policy reform in both Argentina and Brazil, combined with establishment of the MERCOSUR market, agriculture in both countries is now more closely aligned with world markets. A movement toward less government intervention and freer trade is expected to spur both countries to higher levels of growth, investment, and trade. The stage seems to be set for an even greater presence of South American agriculture in world markets.

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