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Foreign and Commonwealth Office

London SW1A 2AH

17 June 1988

Dear Nigel,

Agriculture and the Toronto Summit

Following the Prime Minister's briefing meeting with the Foreign Secretary and the Chancellor yesterday, the Foreign Secretary has reflected further on how best to handle agriculture at the Toronto Summit.

Our key message must be the need to give a significant political impetus to the GATT agricultural negotiations in Geneva in the run-up to the Uruguay Round Mid Term Meeting (MTM) at Montreal in December. A successful agriculture negotiation will be a necessary stimulus to further agricultural reform in the EC, the US and elsewhere. Agriculture is also the key to a successful Round as a whole, and thus to the strengthening of the GATT system which is clearly needed.

The main need is to break the current deadlock. Despite agreement in OECD (1987) on principles to govern reform, and (last month) on the aim of MTM agreement on a "framework approach including both short term and long term elements", the EC and US remain far apart. The Americans continue to insist on setting long term targets (on the basis of their "zero option" proposal to abolish all support other than decoupled income assistance by the year 2000) before short term action can be addressed. This perfectionist approach is politically convenient to the United States. But it is not realistic: it is reasonably certain that even the US will still be supporting their farmers by the year 2000. The EC has so far refused to discuss long term targets and has made proposals for short term action which imply little further CAP reform beyond the Brussels Summit decisions. Many Community Member States want to rest on the February laurels. There is a big gap to bridge.

We therefore want Summit leaders to instruct their representatives in Geneva to get down to serious negotiations, rather than continuing to camp on unrealistic positions. The US will have to accept, implicitly at least, that their zero/2000 target is simply not a basis for negotiation. They must also acknowledge that the Brussels CAP reforms constitute a significant step. The Community must be brought to accept that further steps are inevitable - and desirable - and that

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they will be easier to sell domestically as part of a multilateral agreement to reduce agricultural support. We must also acknowledge that others as well (New Zealand, the US) have made some moves, even if these, too, are only first steps. The Cairns Group idea of a "down payment" of short term measures, coupled with a framework for longer term reform, could provide a catalyst to bridge the EC/US gap - once serious negotiations have started.

But the negotiators also need the tools for the job, and if the negotiations in Geneva are to succeed we need a way of comparing existing levels of support and protection, and for measuring reductions made. The OECD's producer subsidy equivalent (PSE) - which has the backing of all important GATT parties except Japan - measures the total impact of the full range of support policies on producers' incomes. It is not ideal, but it is the best basis available. It allows support to commodities to be compared within and between countries. It can measure the impact of all policies - not just the export subsidies used by the EC, but also import quotas or price controls such as those used in Japan, and the deficiency payments used in the US. It provides a measure of overall levels of protection and support, and a means by which targets for reduction can be set and progress monitored. I enclose a background note which explains the PSE concept more fully. A recent Commission paper tabled in Geneva recognises the important role a form of PSE could play in the negotiations. While concentrating on the short term, the paper acknowledges - in line with our thinking - that PSEs could provide the necessary link between short and long term measures, and the mechanism by which credit could be obtained for recent CAP reforms.

PSE
x p sub sid
imp port quotas
price controls
deficiency
payments

Against this background, the Foreign Secretary believes that we should seek firm Summit endorsement, reflected in the Communique, for:

- (a) the statement in the OECD Ministerial communique that the MTM should add impetus to the negotiating process;
- (b) the OECD commitment to seek a framework approach (including a PSE type measure) with long term and short term elements (including a freeze on support);
- (c) the need for concrete progress by the MTM. We particularly want a commitment from the Summit on this.

I enclose a note on which the Prime Minister may wish to draw, with President Reagan in particular, to emphasise the significance of the Brussels reforms and the recent stock reductions. We need to convince the Americans that:

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(a) the February reforms were a major, and politically difficult, step forward;

(b) it is too early to judge their effectiveness: but if they do not work as intended, we shall insist in Brussels that they be strengthened;

(c) we - and our Community partners - recognise that they are only the first step in a continuous process of reform.

Copies of this letter go to Alex Allan (HM Treasury), Shirley Stagg (MAFF), Neil Thornton (DTI) and Trevor Woolley (Cabinet Office).

Yours sincerely,
L Parker

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WORLD TRADE AND AGRICULTURE: A ROLE FOR PRODUCER SUBSIDY EQUIVALENTS

1. If it is to meet the objectives set at Punta del Este the GATT negotiation on agriculture will need a means of measuring and comparing farm support policies in different countries. The Producer Subsidy Equivalent, which measures the impact of agricultural policies by the amount they raise producer incomes is the best approach.

Why the Need for a Measure of Support?

2. The Punta del Este Declaration on Agriculture speaks of dealing with those policies which "directly or indirectly affect trade". The formulation recognises the historical failure of the GATT to solve agricultural problems and points to the need to bring all policies which encourage production within the disciplines of the GATT. To deal with these problems it is necessary to measure the aggregate effect of all the policies which bear on the decision to produce a particular commodity.

Which Properties should an Aggregate Measure have?

3. An aggregate support measure should:

- be easily understood and clearly relevant to the objective of reducing support to production
- allow all types of support to be compared on an equal footing
- measure the size and speed of policy changes over time and their impact by commodity and country
- allow flexibility in the choice of policy mix while ensuring transparency
- be economical with data
- be widely acceptable.

Why the Producer Subsidy Equivalent?

4. The PSE measures the impact of a policy by the sum of money by which the policy raises producers' income. This is measured either by the direct budgetary transfer to the farmer or by the price raising effect of policies which tax consumers. The price effect is in turn measured by the difference between world prices and domestic producer prices. Thus the PSE allows policies such as import quotas (US milk and sugar; Japanese rice) or intervention buying schemes (EC grains, milk, beef) to be added to or compared with direct budgetary transfers (US deficiency payments; EC oilseed aids, set aside payments; fertiliser subsidies).

5. The PSE is built up by policy and by commodity. That gives flexibility over the coverage of both. It allows the classification of policies by the extent they give incentives to increase

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duction. It also allows support to commodities to be compared within countries and between countries.

6. The OECD has already calculated PSE for all of the major developed country players in the GATT negotiation. That work has clarified the inevitable conceptual and data problems and allowed a degree of consensus on how they can be managed.

How could PSE be used?

7. There are three possible approaches:

- the first is as a simple monitoring tool as in OECD;
- the second is to use the PSE as a means of setting targets for overall cuts in support and monitoring progress but leaving commitments to be made in terms of specific policy changes;
- the third is to set negotiating objectives and bind commitments in terms of PSE after the manner of a tariff negotiation.

8. Of these the second has less drawbacks than the others. It would minimise technical problems. It would also focus attention on policies and therefore allow issues such as import access to be addressed directly.

	<u>1986</u>	<u>1980</u>
U.S.	35%	15%
EEC.	49%	36%
Japan	75%	54%

i.e. the propⁿ of the producer's income which comes from subsidy.

CAP REFORM FACT SHEET

(i) The European Council agreement consists of:

- a legally binding ceiling for agricultural expenditure to reduce rate of growth of spending to less than growth in GNP, i.e. to less than 2% per year in real terms by 1990, compared with 10% a year before.
- stabilisers for each individual commodity: reduce prices and save about \$4 billion of agricultural spending between 1988-1990.
- for cereals: cumulative 3% price cuts for four years (ie total of 12%) if production exceeds the MGQ. Savings of c. \$4 billion over 4 years.
- for oilseeds and proteins: unlimited price cuts in proportion to the excess of production. Should generate extra savings of nearly \$1 billion between 1988-1990, in addition to savings from existing oilseeds stabiliser of about \$1 billion annually.

(ii) Putting the agreement into practice

- Since February the Council has agreed:
 - legal texts implementing the agricultural stabilisers,
 - a Budget Discipline Decision laying down the rules enforcing the Agricultural Guideline and its permitted rate of growth.

- the Commission have presented their 1988 price fixing proposals within the Guideline, and their draft 1989 Budget within the 1989 Guideline.
- an Inter Institutional Agreement between the Council, Commission and European Parliament will strengthen agricultural budget discipline by associating the Parliament with the Brussels European Council Conclusions.

(iii) Effect on the food mountains

It is too soon to see the effects of these reforms. But, in the dairy sector where there is already a stabiliser - milk quotas, introduced in 1984 and strengthened under British Presidency in 1986 - the reduction of intervention stocks has been impressive. The figures for the last 12 months are as follows:

UNSOLD STOCKS IN THOUSANDS OF TONNES

	End of April 1987	End of April 1988	<u>Percentage reduction over 12 months</u>
Butter	943	432	54%
Skimmed Milk Powder	762	40	95%