

Next Generation of Agriculture and Agri-Food Policy

Economic Backgrounder: Macro-economic situation and outlook



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The Next Generation of Agriculture and Agri-Food Policy – A Federal, Provincial, and Territorial Initiative

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Situation macroéconomique et perspectives*



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Macro-economic situation and outlook

Introduction

This report examines the key forces that will drive supply and demand for agricultural commodities over the 2006-2015 period. It considers both the international and domestic trends that will affect key sectors.

This analysis will help identify which countries will present new market opportunities and which will be competing with Canada in key commodity markets. Understanding the evolution of agricultural commodity markets will help stimulate innovation to maintain and increase competitiveness for Canadian agriculture.

Key messages

The Canadian agriculture and agri-food industry has many strengths that create opportunities for a successful future. It is a diverse industry being affected in many ways. Some sectors, such as horticulture, are enjoying strong markets while others, such as cattle producers, are recovering from the effects of Bovine Spongiform Encephalopathy (BSE).

Grain and oilseed prices are in a long term decline, creating strong pressures for producers to expand their size and adopt new production processes.

Supply management (dairy, poultry and eggs) prices and incomes are stable and innovation is driving increased farm sizes.

Producers are being challenged by strong foreign competition but have many opportunities with the opening of new markets and the economic growth of developing countries.

The diversification of Canadian agriculture into more value-added products is consistent with the evolution of world markets. Producing commodities to be used in non-food ways, such as biofuel, represents a new opportunity for Canadian farmers and processors.

MACRO-ECONOMIC SITUATION AND OUTLOOK¹

International

The world economy is projected to show positive growth throughout the 2006-2015 period. Despite the recent doubling of oil prices, overall inflation rates are likely to be relatively low in developed economies as a result of the increased labour productivity and the increased globalization of markets.

The overall pace of economic activity is expected to be concentrated in emerging markets while it is likely to be slow in Western Europe and Japan.

Moderate growth is expected to continue in the U.S. while China and India are expected to experience significant economic growth.

Over the next decade world population growth is expected to slow as a result of lower birth rates in developed countries and the spread of AIDS. Most of the increase in population will come from developing countries, with Asia showing the largest absolute increase and Africa the largest percentage increase. The trend toward more urban population and strong income growth in China, India and Latin America should stimulate demand for processed food products.

Overall, all of these factors are likely to result in increased demand for agricultural commodities.

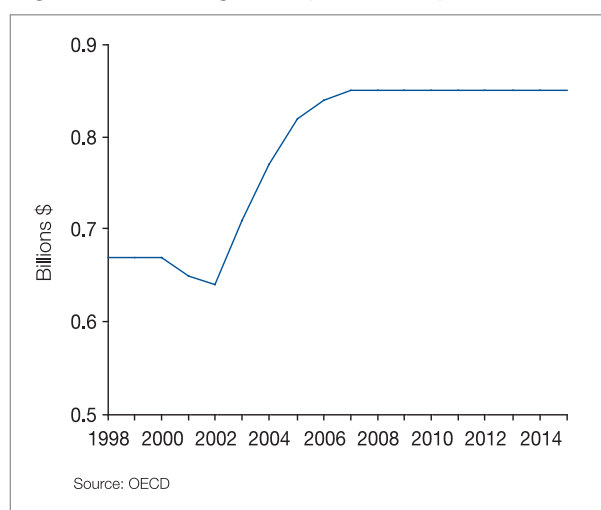
¹ The projections reported throughout this document are from the OECD-FAO Agricultural Outlook 2006-2015.

Domestic

The Canadian economy is expected to experience sustained growth over the medium term. Canada's real GDP is expected to grow an average of 2.9% annually between 2006 and 2015.

On May 3, 2006 the Canadian dollar reached \$0.9 US, an appreciation of almost 30% since 2002 and is expected to remain strong over the medium term.

Figure 1: Exchange rate (US\$/CAN\$)



Canada's strong dollar puts pressure on the agriculture and agri-food supply chain, whose prices are set in world markets. Normally this would be somewhat offset by lower input prices, but rising oil and other energy-related prices have kept input prices high.

High energy costs affect each commodity sector differently; fuel and fertilizers are used more intensively in crop production than they are in livestock production. Within the crop sector this will likely lead to a shift toward crops that require lower input use.

Potential growth opportunities in domestic markets will likely be value-added and niche market products as a result of expected stable population growth and moderate income growth. The diversification of Canadian agriculture into more value-added products is consistent with the current evolution of world markets. Producing

commodities to be used in non-food ways, such as biofuel, represents a new opportunity for Canadian farmers and processors.

WHEAT AND COARSE GRAINS

International

Competitive, low-cost, non-subsidized exporters such as Argentina, Brazil, Russia and Ukraine are expected to continue gaining export market share.

Driven mainly by yield increases, production of wheat and coarse grains is expected to increase an average of 1% per year.

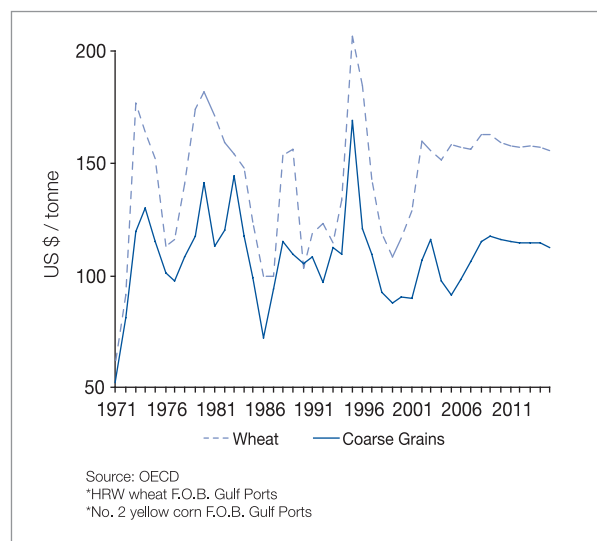
Wheat

Demand for wheat is driven by food use (72% of all wheat). Wheat price and stocks are expected to remain stable over the outlook period. Global wheat imports are expected to increase, especially in developing countries.

Coarse grains

Coarse grain prices are likely to be boosted by increasing demand for feed and ethanol production. The US remains the leading producer, consumer and exporter of maize. However, expanding corn-based ethanol production is projected to increase corn use for ethanol to approximately 25% of domestic use by 2015, which will limit the country's export growth.

Figure 2: World wheat and coarse grain prices



Increasing incomes and urbanization are expected to lead to increases in meat demand and therefore livestock production. With increasing world livestock production, the animal feed market will grow in tandem to meet feed demand requirements.

Domestic

Establishing a 5% biofuel content on road transport fuel could lead to an increase in local demand for wheat and coarse grains.

Wheat

Canada's wheat production is estimated to have an average annual growth of 0.2% and Canada is expected to remain a major wheat-exporting country. Industrial use of wheat for ethanol production is expected to increase in Western Canada.

Coarse grains

Canadian demand for coarse grains is expected to be strong because of the anticipated growth in ethanol and livestock production. Over the medium term, corn imports from the US and domestic production of corn and barley are also expected to increase due to these factors.

As fertilizer (i.e. nitrogen) prices are related to increasing natural gas prices, in the short term, corn acreage could be negatively affected as producers substitute to less nitrogen intensive crops such as soybeans and forages. However, if the price of natural gas returns to more normal levels, there should be a return of acreage planted to corn. Overall, the estimated average annual growth in production for coarse grains is approximately 2.5%.

OILSEED AND OILSEED PRODUCTS

International

Income growth, especially in developing countries, is expected to lead to continued strong demand for vegetable oils as well as protein meals used in livestock feeding. This trend is expected to keep growth in global trade in oilseeds and oilseed products well above wheat and coarse

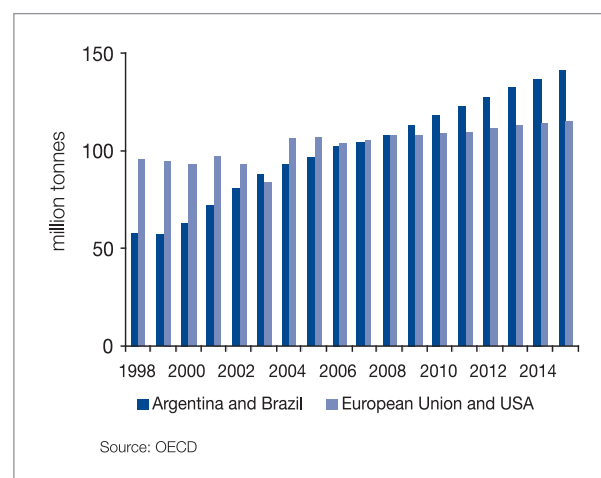
grains levels. Oilseed meal demand is expected to increase by 30% between 2005 and 2015. China will rely on oilseed imports to fill its increasing need in animal feed and is expected to be the largest world oilseed importer by 2015.

Brazil and Argentina are expected to reinforce their positions as leaders in the production and export of oilseed. Their production is projected to increase by 58% and 34%, respectively by 2015.

In Europe, the increase in oilseed production is driven by biodiesel production, which uses rapeseed oil as a feedstock.

After relatively low prices of oilseeds and vegetable oil in 2006, prices should recover over the outlook period. However, with increased supplies of oilseed meal and dried distilled grains coming from biofuel production it is expected that oilseed meal prices will only recover moderately.

Figure 3: Major producers of oilseeds

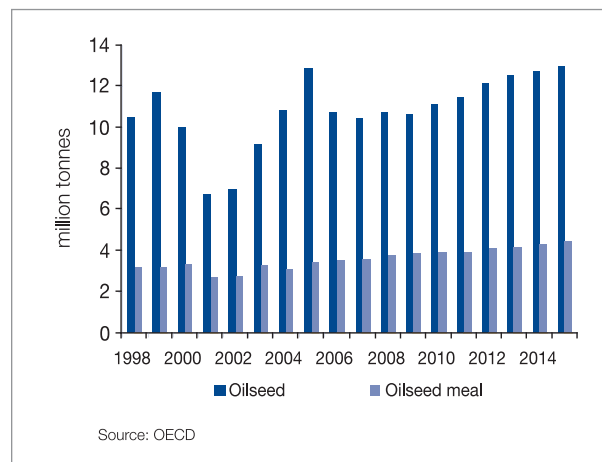


Domestic

Oilseed production is expected to increase slightly throughout the baseline as the strong demand for vegetable oil will positively impact canola production due to its high yield of vegetable oil. Consumption of oilseed meal is expected to follow the growth of livestock production.

Oilseed and oilseed meal prices are expected to decrease in the short term but should recover over the remainder of the projection period.

Figure 4: Production of oilseed and oilseed meal in Canada



The technology to process vegetable oil into biodiesel is evolving quickly. Significant development could positively impact the demand for canola in the future.

RED MEATS

International

Meat demand is mainly driven by income and population growth and urbanization. Considering these factors have been growing the fastest in developing countries, growth in livestock product trade has become increasingly dependent on demand from developing countries as demand in developed countries has been rather stable.

Over the past decade, a series of animal diseases or food safety crises such as Foot-and-mouth disease (FMD) in Europe and Latin America and BSE in North America has exacerbated the segmentation of international meat markets and markets will remain very sensitive to animal health outbreaks and regulations.

Despite these incidents, imports of red meats by countries of the Pacific Rim have increased dramatically since 1990. This trend is confirmed in the OECD Outlook, which estimated that nearly

60% of the growth in the world consumption is expected to come from this area.

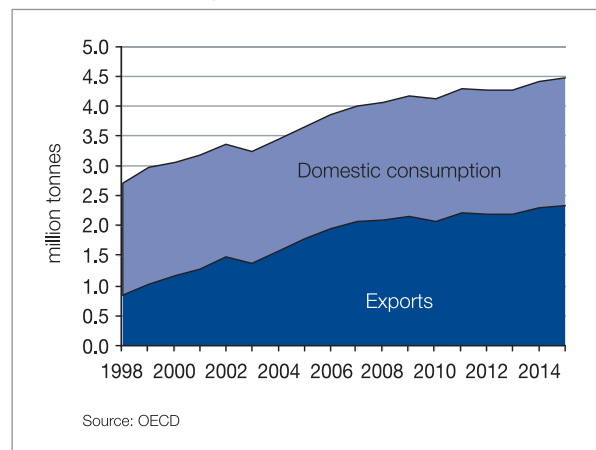
Given normal market conditions, world beef and pork prices are expected to decline as they start the downward trend in their price cycles. Global meat trade is expected to grow by 2.2% annually.

Domestic

Growth in the Canadian red meat industry is tied to export markets. International market conditions remain favourable for Canada since competition from large South American producers is limited by foot-and-mouth disease outbreaks.

Supply conditions, however, will not be as favorable as they were in the 1990s. Animal diseases are affecting Canada's red meat industries. Post-Weaning Multisystemic Wasting Syndrome (PMWS) is affecting hog production and BSE is still resulting in some trade restrictions.

Figure 5: Canadian red meat consumption and exports



Canadian beef trade is expected to rebuild gradually as trade partners are reopening their markets. Over the projection period, Canada should regain much of the market share previously lost. As a result, the difference between Canadian and American steer prices is expected to return to historical levels.

In Eastern Canada hog production is currently affected by PMWS, a globally emergent disease

that has led to high mortality loss. Future growth of hog production could also be limited by environmental constraints.

DAIRY, POULTRY AND EGGS

International

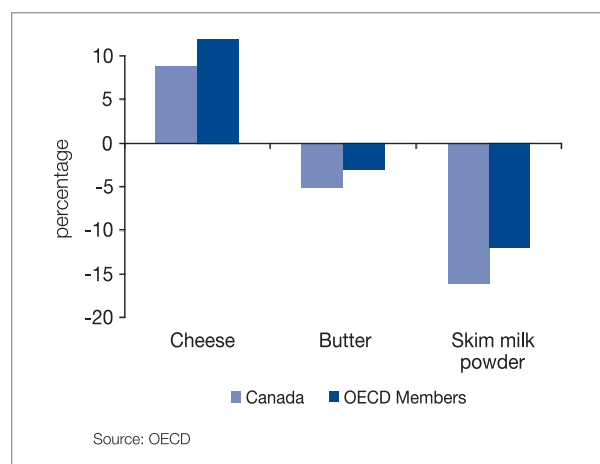
Dairy

Output of milk and dairy products is expected to expand over the projection period. The majority of increased demand for dairy products is expected to be realized in developing countries such as China and India.

After reaching a peak in 2005 and then decreasing, world dairy prices are expected to increase slowly over the outlook period.

Trade of dairy products is expected to increase (with the exception of skim milk powder) as consumption growth outpaces supply in most importing countries. New-Zealand and Australia are projected to reinforce their positions as major world dairy exporters.

Figure 6: Relative change in consumption between 2006 and 2015



Poultry

The spread of avian influenza (AI) has put downward pressure on prices in exporting countries affected by this disease (such as Thailand) while prices are increasing in AI-free exporting

countries such as Brazil. Brazil due to its low production costs, is one of the most competitive countries in the world poultry market.

The poultry market is expected to recover to normal conditions in the outlook period and the price of poultry will be relatively stable throughout the outlook. Poultry is expected to gain market share at the expense of beef in the global trade market.

Domestic

Dairy

Growth is constrained by a relatively saturated domestic market, especially for milk and butter.

Demand for dairy products in Canada is expected to increase only slightly in the next ten years, driven mainly by population growth. The Canadian dairy market is mature, characterized by an aging population consuming less dairy products. As a result, consumption growth is expected to remain low and confined to certain products, namely specialty cheeses and yogurt.

Poultry

Growth in per capita consumption of poultry is expected to continue increasing but at a slower pace than it was in the 1980s and 1990s.

Figure 7: Poultry consumption in Canada

