NEW CHALLENGES IN INTERNATIONAL DAIRY TRADE

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Extract: *International trade in dairy products is in a vigorous phase of development stimulated by demand growth in key import markets but underpinned even more by the progressive reduction of supply distortions caused by subsidised exports. These positive trends are especially important for the New Zealand dairy industry.*

The further economic rationalisation of international dairy trade will depend on a continuation of the agricultural trade reform processes being pursued in the WTO. The priority need is to continue the momentum on the phase out of export subsidies.

These developments are opening up new fronts of activity for both for businesses involved in the production and marketing of dairy products and for policy makers. The most critical factors likely to shape future trade flows will be the growth in demand for imports, especially in Asia, the adaptation of European Union policies, decisions in the United States on the approach to dairy industry support and the reorientation of the Australian and New Zealand industries from centralised defence to marketing offence.

Introduction

I appreciate this opportunity to present a New Zealand view on an important aspect of trade in livestock products to such an esteemed group.

I should stress at the outset that I can make no claim, in what I say, to any particular academic expertise. The perspective that I will present is that of a trade policy practitioner involved in the day to day issues arising from the operation of international dairy markets, and the effects on these markets of government policies on trade and on support for domestic dairy industries.

It is refreshing to have the chance, such as the one which this forum provides, to be able to stand back from the day to day grind and contemplate the wider trade and policy trends.

Expanding Horizons

From the point of view of the New Zealand dairy industry, these wider trends are, I believe, mostly <u>relatively</u> positive. They are opening up important new horizons for New Zealand's dairy export business. And for dairy industry businesses worldwide as well; producers, manufacturers, traders and marketers all down the value chain.

These positive international trade trends are especially important for the dairy industry in New Zealand, which is dependent to an exceptional degree on international trade. Close to 95% of the milk produced on farms in New Zealand is manufactured into commercial dairy products that are exported to customers in foreign markets.

These exports make up more than 20% of New Zealand's total export trade. So the trends are important for New Zealand as a whole. The dairy industry is New Zealand's pre-eminent export industry. If the dairy industry is expanding and providing a healthy base for investment and employment growth, as it is at present, the spin-offs for the wider economy are very significant.

International Dairy Markets

Obviously there are many factors which contribute to the healthy development of any industry. But at the end of the day it is the vibrancy of the markets for its products that count for most.

Right now international dairy markets are in a relatively vigorous phase of development.

These markets comprise an incredibly complex matrix. I want to emphasise the plural – markets – because international dairy markets are extraordinarily varied. The concept of a "world" market for dairy products as frequently referred to in econometric models, is nowhere to be found in the real world. Supply and demand for milk and dairy products do not interact in any global way.

There are a number of reasons for the variegated structure of dairy markets. One, plainly, is the wide range of different products that can be manufactured from milk. Although cream cheese and milk protein isolates, for instance, share a common origin in the udder of a cow, the dynamics of the markets for these individual products are vastly different.

A much bigger factor in the differentiation of markets is, however, the segregation of them caused not by technical factors, but by government policies.

Nearly all countries have a domestic dairy industry, even where the laws of comparative advantage would dictate otherwise. Nearly all are regulated because of the political, social, and economic importance of farmgate prices for milk. The profound level of government intervention is thus a dominating influence on the way in which markets are structured and operate and on international trade in dairy products.

It is an over simplification, but, I believe, a constructive one, to think of international dairy trade in terms of two broad classes of market.

First, there are what may be termed the “controlled access” markets of the major industrialised economies of Europe, North America and Japan. These markets are segregated one from another by trade controls, and each has a distinct pricing structure. Imports into these markets are tightly regulated by quota restrictions and other means to protect domestic prices.

The second category of markets is what I like to term “competitive supply” markets. These are located mainly in Latin America, Asia, Russia and its former USSR neighbours, and the Middle East and North Africa. Although many of the countries in these regions have large, often politically sensitive, dairy industries they operate relatively open trading policies, which encourage competition amongst suppliers.

However, even in these markets government policies historically have dominated the business environment. The principal influence on price competition in competitive supply markets is the subsidies applied on exports from the European Union, the United States and others.

Consumption Growth

Why is international dairy trade in a relatively vigorous phase of development as I suggested before? There are in my view two principle reasons.

Firstly, commercial consumption of milk and milk products in a number of key markets is growing. This is not happening in any spectacular fashion and nor is it a general phenomenon. Indeed, looked at in terms of aggregate world production and consumption of milk, there has been very much a static picture for more than twenty years. Production and consumption of milk in 1980, according to the FAO, amounted to roughly 470 million tonnes. Last year the best indications are that it had crept up in only a minor way to around 480 million tonnes.

In some markets consumption actually has been contracting. This has been most apparent in Russia and some countries of Eastern Europe. But contraction in these regions has disguised the growth that is taking place elsewhere. And this growth is being serviced predominantly by imports, which makes it very important in international terms.

Much of the growth that is occurring is taking place in Asia, in the Middle East, and in some parts of South America. These are the markets that count most as far as New Zealand is concerned.

This consumption growth invariably is linked directly to economic development and growth in the countries concerned. As incomes rise, so does demand for not only milk, but also all manner of dairy based foods, from yoghurts and dairy desserts, to ice cream and cheeses in a great variety of forms.

In economic terms, this demand is highly income elastic. And the good thing from the supplier's viewpoint is that it tends to be price inelastic. Both of these characteristics were clearly in evidence during the Asian economic crisis of 1997-99. Import prices for dairy products were under tremendous upward pressure as a result of currency devaluations. Demand, however, was virtually unaffected. Where it was subdued, this was mainly attributable to contracting wealth and income, not prices as such.

Another encouraging thing about this growth is that it can be expected to be maintained long term. And it has a long way further to go. Per capita consumption of milk products in countries such as Malaysia and China is still very low compared to the standards of North America and Europe. It will be a long time before consumption levels in Asia come anywhere near the levels of Europe. Perhaps they never will, but even doubling from their current levels, which is a very real prospect in the next ten to fifteen years, will carry with it significant new opportunities for trade and international business. This is because most of that expansion in consumption will need to be supplied by imports.

Containment of Synthetic Supply

The second factor underpinning the improvement of international dairy market conditions is less obvious but more important, especially for now and into the medium term. It is what is happening on the supply side. It is the measures which are now in place limiting, at least to some initial degree, the impact on those markets which are open to competitive supply, of the artificially stimulated surplus production of the major Northern Hemisphere producers.

These economically fake supplies, available only by way of the medium of export subsidies, have in the past had a profoundly distorting influence on the composition and pattern of international dairy trade. They still do today but whereas in the past the market distortions they have caused have tended to deepen, compounding one on the other, now the movement is in the other direction. Some of the worst distortions are beginning to be ironed out.

These export subsidies have reversed the natural economic order of things as far as producers are concerned. The potential of those who comparatively are the most efficient producers has been suppressed. New Zealand has been in the very front rank of those most affected in this way.

On the other hand, less efficient producers, in Europe especially, but also in North America, have, with the artificial stimulus subsidies have provided, become major exporters. The results have been perverse. For example, Germany became during the 1980s and 1990s a major exporter of butter. The United Kingdom, historically the biggest importer of dairy products in the world, developed a major export trade in cheese to Japan.

It is not only producers who have been adversely affected by this screwed up, bogus pattern of supply. Importers have had to deal with widely gyrating prices caused by capricious changes in subsidy levels. This has blunted the orderly development of business and trade, and the building of consumer demand, which depends on, more than anything else, secure and stable market conditions to provide the foundations for vigorous investment, long term.

The control of export subsidies is part of a wider process of international dairy trade rationalisation that is now underway.

This does not mean that there is any less disposition on the part of governments to support and protect dairy farmer incomes. Quite the contrary. But there is, I believe, a growing acceptance that this should be done by direct means rather than by means of product price supports and other comprehensive market intervention measures

This process of rationalisation and change is by no means revolutionary. It is slow and gradual. Nevertheless, it is of profound significance for the improved development of international dairy markets. It is especially important for New Zealand. Changes at the margin are what count. Just as New Zealand has been in the front rank of those affected adversely by subsidies, it is now, and will be in the future, in the first group of countries to benefit from a more economically rational approach to international dairy trade.

WTO Negotiations

Essential to these developments is the WTO. It will be apparent from what I have said that we in the New Zealand dairy industry regard the WTO as of the utmost importance.

The Agreement on Agriculture and the commitments on market access and export subsidy reductions made in conjunction with this agreement, applied from 1995, marked a critical turning point for international dairy trade.

It was however, only a turning point, not a destination. There is still an awfully long way to go. It is vital that the process of reform is continued. The benefits of what has been achieved to date are clear for all to see. And they have involved much less trauma for those required to make policy adjustments than was foreseen. Indeed, there has been no real trauma at all! Market rationalisation is not a zero sum game. There are benefits for all.

Negotiations on the next phase of agricultural trade reform, as mandated in the Agricultural Agreement, are already underway in Geneva. We are optimistic that there will be agreement this year on an agenda for negotiation of other issues as well, so that a comprehensive package of reforms can be agreed at an early date, maintaining the established momentum of change.

Our objectives for the negotiations are simple and straightforward. At the forefront are:

1. Number one, the elimination and outlawing of export subsidies as soon as possible.
2. Number two, so far as market access is concerned, the complete removal of duties on imports within tariff quotas and a significant, 100 percent, expansion of these quotas, which in most cases remain very small relative to the size of the markets concerned.

I should say a word also about what are not among our objectives. We do not advocate the wholesale dismantling of agricultural support. We have no problem with whatever rural support polices governments want to apply provided they are delivered in ways which do not distort markets to the detriment of producers elsewhere, or consumers alike.

New Issues

The changing and improving, environment for international dairy trade is generating new issues and challenges on a number of fronts. These are not just in policy terms but in terms of capturing, to the fullest extent possible, the new business opportunities that are being spawned. Old assumptions are in need of review; long-standing stereotypes need to be reassessed.

There are in my view four major fronts of activity that will be particularly critical in shaping the development of international dairy trade in the next five years.

First, and especially critical, is how the potential of emerging markets, particularly those in Asia, are tapped. These new market opportunities are dynamic and exciting. They need to be nurtured. This is primarily a commercial challenge for the private sector; where it directs investment and entrepreneurial drive.

The second front involves the policies of the European Union; how they are going to be adapted to take account of, on the one hand, the further developments in the WTO and, on the other, the further enlargement of the Union.

The policies of the European Union still loom powerfully over international dairy markets. The European market operates within a tightly controlled framework of measures that regulate both production and at the same time manipulate consumption through subsidised use of surpluses in the food industry and in animal feed.

Policy-makers in the European Union are going to need to grapple with how they:

- remove quota controls on milk production;

- shift the delivery of support for farmers' incomes from indirect methods, via market support for milk and dairy products, to more direct means of support.

The third big issue is the future direction of United States dairy policy.

The US dairy industry is primarily focused on its large and hugely wealthy domestic market. This domestic focus, paradoxically, has been reinforced by the WTO disciplines on subsidised exports. These have largely negated it as a competitive threat to international dairy markets, for so long as its price support programme is unaltered.

How the Americans deal with their schizophrenia towards international trade in dairy products will be critical, not just for themselves but for international markets generally. They will have to choose between either continuing with domestic price support arrangements, or adapting a more market approach to the regulation of production and supply. Choosing the latter course could see the United States become a major, possibly the major, supplier of international dairy markets. The other option, the politically softer one in the short term, looks to me to be pretty much a dead end street for the industry.

The fourth front of activity, and from my point of view the most interesting, is the restructuring and further development of the dairy industries in Australia and New Zealand.

In the past the principal factors limiting the potential of these industries have been more political than economic or commercial. Foreign government policies have strangled their economic potential and clouded their commercial enterprise by hijacking their natural markets. Priority has had to be given to collective responses through the pooling of returns and other measures to mitigate the effects foreign government induced market distortions.

There is now less need for such measures. Hopefully there will be even less need in the future. This foreshadows a restructuring of the industries along more conventional, open competitive lines. This process is already underway. It is more or less completed in Australia and is unlikely to be long delayed in New Zealand.

Conclusion

As I said somewhere near the beginning, international trade in dairy products is incredibly complex. I think, however, that, slowly, it is becoming more straight forward but no less interesting a subject for study as a result.

Thank you.