



The Babcock Institute

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WORLD PRICES FOR DAIRY PRODUCTS REACH UNPRECEDENTED HIGHS FROM SHORT SUPPLY AND STRONG DEMAND

During 2007, world market prices for butter, cheese and milk powders have increased dramatically, reaching levels about double those observed only a year earlier. Strong world prices have had a major impact on U.S. milk prices. A direct effect is through large U.S. exports of skim milk powder and whey at attractive prices. A secondary effect is in holding domestic cheese and butter prices at the high world prices, less freight costs, even though U.S. is not a major exporter of cheese and butter.

What caused the sharp elevation in world dairy prices? Both supply and demand side factors played a role. On the supply side:

- A severe 2006 drought in Australia, a leading dairy exporter, sharply reduced milk production and curtailed exports, especially of butter and skim milk powder.
- Milk production in the European Union (EU) was down in 2006 because of changes in EU dairy policies and widespread dry weather conditions that cut feed availability.
- Argentina and India embargoed exports of skim milk powder.
- U.S. government inventories of skim milk powder were exhausted in 2006, removing buffer stocks that had previously moderated world price increases.
- Conversion of farmland from feed production to biofuel production in many countries, especially the U.S. and EU, elevated feed costs and correspondingly raised the cost to produce milk.

Demand side factors included:

- Cheese consumption world wide continued to show strong growth. This factor was particularly pronounced in the EU, where limited milk supplies were diverted from skim milk powder driers into cheese vats.
- Strong economic growth in Asia, especially China, promoted stronger demand for dairy products. For example, Asian skim milk powder imports are expected to be up 11 percent in 2007 over last year.

How long can this ride be expected to last? Given the large number of contributing factors, that's hard to predict. But higher farm-level milk prices world wide will eventually lead to more milk. Key factors in when this happens are the following:

- *Evolving changes in EU dairy policy.* EU milk quotas and overproduction penalties are under review, and quotas are likely to be increased as early as April 2008. Several EU member states would likely expand milk production to match quota increases.
- *The recovery of Australian milk production.* Successive droughts in 2004 and 2006 have discouraged many Australian milk producers.
- *Milk supply response in the U.S.* The U.S. will likely expand production by 4 percent in 2007, and even more in 2008 given current farm milk prices.

