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Introduction

In April, I had the privilege to attend the Minnesota-Wisconsin Dairy Policy and Leadership Conference, which included a session on international trade of dairy products. In this article, I will summarize a paper delivered at that conference by William Dobson of the University of Wisconsin.[1]

During the 1990's, government reduced its financial support for the dairy industry. With the outlook for the Commodity Credit Corporation (CCC) to reduce its purchasing of surplus dairy products, there was a call for expanding U.S. exports of dairy products.

Today, we find that deregulation of dairy has been much less sweeping than first anticipated by the industry. The government price support program was first extended through May 2002 and then again with the new farm bill. Although General Agreement on Tariffs & Trade/World Trade Organization negotiations helped to liberalize international dairy markets, many barriers to international trade still exist.

Potential for Expanded Exports

U.S. milk producers are not the lowest cost producers in the world, but their production costs are low enough to make U.S. dairy exports competitive abroad. Only dairy producers in the pasture-based countries of New Zealand, Australia, Argentina, Uruguay, and a few other countries have lower production costs than the U.S.

Some producers in the U.S. have costs as low as those in pasture-based countries. But the cost advantage of the U.S. is not strong enough to encourage international market expansion, especially with strong CCC backup for unsold products.

Trends in Exports

In terms of tonnage, the U.S. is a net exporter of dairy products but is a net importer in terms of value. Its major export items are nonfat dry milk (NFDM) and dry whey. Imports are mainly expensive cheese and sometimes butter. Although the U.S. is a net importer of cheese, exports are growing faster than imports. Export tonnage has grown from 8% of total U.S. international cheese trade[2] in 1990 to 21% in 2001 although the growth has not been smooth. Meanwhile, butter trade changed dramatically during the same time period. Butter exports reached a high of 99% of U.S. butter trade in 1994, and then declined to 2.5% in 2001. Exports of NFDM increased from 91% of U.S. NFDM trade in 1990 to 99% in 1994, where it has remained since then.

In total value, the U.S. is a net importer of dairy products, but the ratio of imports to exports is declining. In 1990, imports accounted for 72.5% of the total dollar volume of the U.S. international dairy trade. As of 2001, imports were 60.5% of total dairy trade.

Meeting the Competition

Price competition is the most powerful factor that governs import-export traffic. Except for the price of butter in 1995, the prices of U.S. cheese, butter, and NFDM exceeded world prices through the 1990s and into 2000s. A significant contributor to the problem of high prices of U.S. dairy products has been the

[1] Dobson, William. "Would U.S. Dairy Firms Increase Long-term Profits by Becoming Bigger Exporters and Bigger Investors in Foreign Dairy-Food Businesses?" *Market and Policy Briefing Paper*, No 75, Department of Agricultural and Applied Economics, Univ. of Wisconsin-Madison, Madison, WI 53706.

[2] Total trade is the sum of imports plus exports.

strong U.S. dollar. The stronger the U.S. dollar, the cheaper are the prices of foreign goods for U.S. buyers and the more expensive are U.S. goods for a foreign buyer. Thus, the stronger the dollar, the more important international competitiveness becomes for an U.S. exporting industry.

Several economic factors have contributed to the relatively high costs of U.S. production. These include tariff-rate quotas employed by the U.S.[3], a dairy price support program to protect high cost producers, price support programs for feed grains and oil seeds that keep feed costs higher than they otherwise would be, and differences between the supply-demand conditions in the U.S. and the rest of the world. It should be noted that the dairy price support policy is irrelevant in world trade when U.S. open market prices are above support prices, as they were for extended periods of time during the 1990's. Further, the moving from supply control for corn and soybeans to loan rates and loan deficiency payments (LDPs) has reduced, but not eliminated, the impact on feed costs. The change allows the market price of feed concentrates and supplements to drop below an open market price. However, at the same time, the program supports higher land prices, increasing the price for forage feeds and pasture. Which of these two offsetting forces will prevail will depend on market conditions at any point in time.

Resistance to Deregulation

Past behavior of U.S. producers indicates that they will fight hard to maintain border protection, price support programs, and associated higher domestic milk and dairy product prices. Although consumers would benefit from lower prices if border protection and price support were reduced or eliminated, consumers' political power is small relative to that of dairy producers. However, this resistance may prove to be costly in the long run.

Experience by the New Zealand Dairy Board indicates that early movers in establishing a presence in foreign markets gain about a 15% profit advantage over the second group of entrants. The third round of entrants are in a breakeven situation, while the fourth and later entrants find themselves with negative profits. Continued protection for dairy products is not guaranteed. Tariffs on industrial products have dropped from an average of 40% to 4% of value over the past 60 years. If protection for dairy products goes the same way, it is the early movers that will be in position to survive and grow.

To move the dairy industry from dependence on government support programs to reliance on trade, firms need short-term benefits as well as long-term incentives. A study by Thomas Cox at the University of Wisconsin found that short-run returns on export investment are thin. This study indicates that under a free trade scenario, dairy exports from the low cost areas would increase while the exports from the high cost areas would decrease. Farm milk prices would decline about 26% in Western Europe, 36% in Japan, 32% in Canada and 17% in Mexico. Farm prices would increase about 51% in New Zealand, 32% in Australia, and 17% in Argentina. Prices in the U.S. would change very little in either direction. Thus, according to these results, there is little incentive for U.S. producers and processors to push for freer trade. When the analysis was run under a partial free trade scenario, the results followed the same pattern, but were less drastic.

Compensation for Deregulation

Unilateral deregulation of dairy trade by the U.S. would likely mean that U.S. farm prices would decline. Australia found itself in such a situation when it decided to drop trade barriers. To deal with the problem, it decided in 2000 to pay dairy farmers to accept deregulation. Under a complex compensation package, the average fluid milk producer in Queensland, Australia will receive about U.S.$63,000 over an 8-year period for accepting deregulation. How much it would take to gain support for such a program in the U.S. is unknown. Another question is whether politicians would allow it to remain after farmers received their transition payments.

The move worked in Australia because the powerful Victoria dairy farmer organization concluded that they could gain more in the long run from free trade than they could from the government support programs. It was powerful enough to present dairy farmers with a "Godfather" like offer they couldn't refuse; take the payment for deregulation or take deregulation without payment.

Export Potential

The U.S. dairy exporting strategies have evolved to suit the prevailing economic and legal

[3] A tariff-rate quota is a two–stage tariff. Imports up to a set quota level enter at relatively low tariff rates, while imports over that level enter at much higher rates.

environments. Thus, U.S. dairy exports have gravitated to (1) products that are not priced out of the world market by U.S. tariffs or USDA price support programs, (2) products that can be exported with subsidies, and (3) selected differentiated dairy products.

Dried whey and lactose fit the first group. These products have prices that are competitive in the world market. Whey products have a large number of applications, including animal feed, baked goods, candies, processed meats, infant formulas, nutritional beverages, and other items for human consumption. Some specialized whey protein fractions can command a price of over $220 per pound in pharmaceuticals. The U.S. is one of the world's biggest exporters of whey powder and whey protein concentrate (WPC). The world demand for dried whey has had strong, consistent growth since the 1970s and export potential looks good for the foreseeable future. Dried whey exports increased 185% between 1992 and 2000 to $171 million.

Products in the second group include NFDM and limited amounts of cheese and butter. Under the WTO rules, the U.S. can export 68,000 metric tons of NFDM per year with the Dairy Export Incentive Program (DEIP) subsidies, although this is not sufficient to clear the market of all the U.S. produces. Also, the U.S. can export 20,000 tons of butter with subsidies, but the domestic supply/demand situation is such that the U.S consumes nearly all that it produces. An adjustment in the butter/powder "tilt" could reduce the market price of NFDM, but also could raise the minimum price of butter and encourage butter imports. Moreover, the long-term outlook for NFDM exports is negative whereas the outlook for whey protein concentrate is positive. Unfortunately, the U.S. produces a lot of NFDM and just a small amount of WPC.

The third group is specialty products that include ice cream, fluid milk and cream, and most cheeses. Fluid milk and cream have limited markets, mainly because of high transportation costs. Northern Mexico holds good potential for fluid milk and cream exports given its low tariffs, but non-tariff barriers can be substantial. Also, domestic processors in Mexico are becoming more efficient and competitive. Canadian protection keeps U.S. milk out of Canada.

Ice cream exports have experienced limited growth in recent years. The high prices of premium ice cream have priced the product out of the Mexican market. Exports of specialty cheeses may have increased modestly, but these products face strong competition from Europe and Oceania.

Essentially, U.S. dairy exports have their greatest potential as ingredients products, especially dried whey products and dairy blends. Also, the potential to expand sales of highly differentiated dairy cheeses, nutraceuticals, and pharmaceuticals looks favorable.

Investments in Foreign Dairy-Food Businesses

Direct investment by U.S. dairy food businesses in foreign countries holds potential for good profits for the early movers. While this may be good for the diary food businesses, it provides little direct benefit for U.S. dairy producers unless the business is a farmer owned cooperative. Indirectly, it gives the firms a base from which to market products that can be exported profitably from the U.S.

Implications of maintaining the status quo

Maintaining the status quo is an easy path to choose but it is not without significant risks. Of course, if the domestic demand for dairy products grows, maintaining the status quo is possible. However, in the words of Helmut Maucher, former CEO of Nestle, the U.S. market for dairy products is "flat and fiercely competitive." Therefore, Nestle has placed a priority on expanding sales in growth markets in Latin America and Asia.

The latest projections for market expansion indicate the greatest potential for growth is in Asia due to a growing population and growing incomes. Mexico also holds some potential, but it is a highly competitive area. The potential for Western Europe looks limited by close to zero population growth and limited income growth.

Whether or not U.S. firms choose to ignore opportunities to participate in Asian and Latin American growth potential, European and Australian companies are more than willing to gain control of these areas. Western European firms have strong incentives to expand direct investments in these markets because of zero population growth and sales constraining milk quotas in the European Union. The lost advantage of not being an earlier mover and the potential increase in intensity of domestic competition pose some significant risks for the U.S. dairy industry.

When considering exporting or direct foreign investment, each firm must evaluate its own capabilities and circumstances and determine how and where it wants to grow. But the U.S. dairy industry, as a whole, must keep in mind that government assistance may dry up someday and a secondary market will be needed for products not consumed domestically. The appropriate response for a dairy firm depends on how soon, if ever, such a condition will materialize.

The barriers to expanding direct investments in foreign countries are less troublesome than dealing with border protection, tariffs, and other trade barriers. If, as the former CEO of Nestle believes, the U.S. markets are flat and fiercely competitive, the far-sighted firm will consider making additional foreign investment.

Summary and Conclusions

International trade offers the U.S. dairy industry an additional profit opportunity, though the industry must focus its attention on those value-added products that have not been priced out of the market by U.S. price supports and border protection. Direct investment in dairy food business in foreign countries also holds potential for additional profits, but includes a different set of risks and benefits. Direct investment avoids trade barriers and exchange rates. However, business ethics and commercial laws vary greatly from one country to the next.

In all likelihood, border protection and price supports will be around for the next decade. Thus, whey and lactose hold greater promise of success than do NFDM, cheese, butter, and fluid milk for those seeking experience in international trade.

Current conditions favor the status quo. Nevertheless, the U.S. dairy industry is gathering market intelligence on exporting and foreign direct investment opportunities in dairy food markets. Also the U.S. Dairy Export Council (USDEC), in cooperation with the Foreign Agricultural Service (FAS-USDA), has commissioned and conducted studies of foreign demand for U.S. dairy products. Field operation units have been established in selected promising countries and some market expansion efforts have been undertaken. These have helped with sales of dairy food ingredients and other products that have not been priced out of the market by price supports and border protection.

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