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U.S. DAIRY TRADE SITUATION AND OUTLOOK: 2010

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U.S. DAIRY TRADE SITUATION AND OUTLOOK: 2010

Edward V. Jesse and William D. Dobson[1]

EXECUTIVE SUMMARY

U.S. dairy exports in 2009 fell sharply from 2008, but were still the third highest on record. U.S. dairy imports also fell, but only by about a third as much as exports. As a result, the U.S. dairy trade surplus went from more than $1 billion in 2008 to $100 million in 2009.

Nonfat dry milk/skim milk powder and butter exports dropped the most, together accounting for three-quarters of the overall loss in export value. Exports of whey and lactose—particularly important to Wisconsin—were up on volume, but down in value due to much lower world prices.

The U.S. exported dairy products to 153 countries in 2009. Mexico was the largest export market, accounting for almost 30 percent of total export value. Exports to Asia added another 30 percent of total value. China was the leading Asian destination, with 6 percent of total U.S. dairy exports.

Cheese again led all import items, at just over $1 billion. Imports of high protein milk powders (casein and milk protein concentrate) added another $456 million. The volume of cheese imports continued to follow a downward trend that began in 2004. Cheese export volume fell by 52,000 MT (24 percent) over that time as a result of U.S. cheesemakers increasing production of varieties once available only from overseas sources. MPC imports have also moderated as domestic production has picked up.

The European Union—the primary source of cheese imports—accounted for about 40 percent of total U.S. dairy import value in 2009. New Zealand was the largest supplier of MPC and casein.

U.S. dairy export prospects in 2010 are promising. World demand for dairy products is strengthening with solid real GDP growth in important U.S. export markets. World milk supply is expected to show a 1.0-1.5 percent gain over 2009, but most of the anticipated gain in milk production will come from China and India. China is far from self-sufficient in milk production and will continue to be a major importer. India also supplies less milk than it can use domestically, but is essentially a closed market to U.S. dairy products. Overhanging stocks from large U.S. and EU intervention purchases in 2009 could negatively affect world prices, but we expect 2010 U.S dairy exports to increase about 20 percent in value over 2009.

Trade policy initiatives remained firmly on the back burner in the U.S. and in many other major trading nations in 2009. The recession brought on a 12 percent drop global trade in 2009, the sharpest decline since the end of War II. In this environment, many governments and trade policy officials were more concerned with helping their countries weather the global financial crisis and protecting domestic markets than with trade expansion efforts.

New thinking has emerged in government and trade policy circles that could affect U.S. dairy trade. This is because negotiations for the WTO Doha Round—which began in 2001—appear likely to be abandoned. Unfortunately, the new thinking has produced options that are exceedingly complex and are unlikely to be acceptable to many trading nations. However, a new proposal to make the WTO dispute settlement machinery more "user-friendly" appears to hold promise.

The lack of progress on agricultural trade reform is not good news for the efficient and increasingly export-oriented U.S. dairy industry.

[1] *The authors are emeritus professors in the Department of Agricultural and Applied Economics, University of Wisconsin-Madison. Jesse is Director of Trade and Policy Studies and Dobson is an Agribusiness Economist with The Babcock Institute.*

TRADE UPDATE[2]

U.S. Dairy Exports

Both the value and volume of U.S. dairy exports in 2009 were off sharply from 2008, victims of the global economic collapse that began in the fall of 2008. Overall, volume was down only 15 percent, but much lower world prices pushed the value of dairy exports down by 40 percent.

Among major export items, the largest drop-offs were in nonfat dry milk/skim milk powder and butter. The loss in NDM/SMP export value accounted for 62 percent of the total export value loss; butter 13 percent. On the positive side, exports of whey and lactose were up nearly 10 percent on volume, but down in value by one-sixth due to lower prices. Fresh milk and cream and frozen dairy products showed small gains in both value and volume.

Three categories—whey and derivatives, nonfat dry milk and skim milk powder, and cheese—made up more than two-thirds of export value in 2009 (Figure 1). This overall proportion has been fairly stable over time.

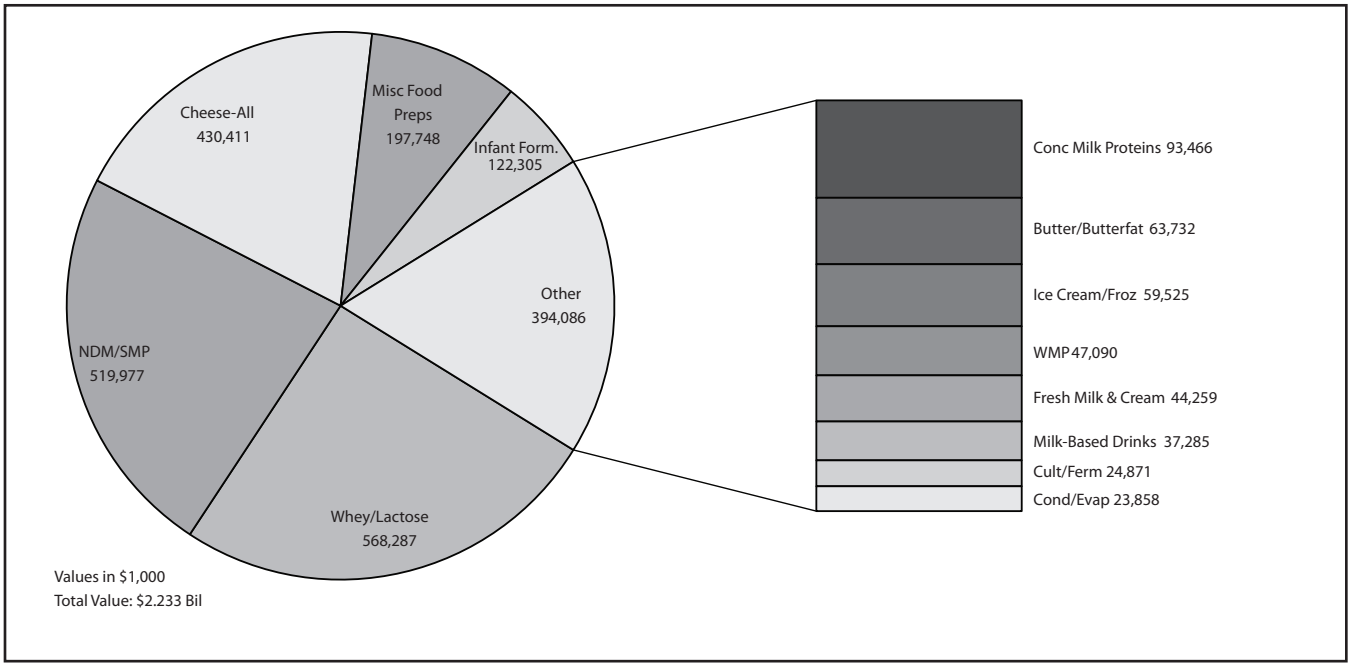
The U.S. exported dairy products to 153 countries in 2009 (Figure 2). Mexico was by far the largest single-country market, accounting for 28 percent of total dairy export value. Canada was in second place at 16.5 percent. U.S. exports to Mexico have been growing rapidly, but dropped sharply in 2009 due to an especially troubled Mexican economy. U.S. dairy exports to Canada have been relatively stable, and are about matched by Canadian dairy exports to the United States.

TABLE 1. U.S. Dairy Exports, 2009 With Comparisons

Product Group	2008		2009		Percent Change	
	$	MT	$	MT	%	MT
Whey/Lactose	682,501	521,185	568,287	571,687	-16.7	9.7
NDM/SMP	1,379,462	391,165	519,977	248,829	-62.3	-36.4
Cheese-All	569,267	131,202	430,411	108,494	-24.4	-17.3
Misc. Food Preps	232,421	103,871	197,748	86,079	-14.9	-17.1
Fresh Milk & Cream	41,052	48,718	44,259	51,121	7.8	4.9
Infant Formula	122,741	31,409	122,305	31,008	-0.4	-1.3
Concentrated Milk Proteins	165,284	33,570	93,466	26,317	-43.5	-21.6
Ice Cream/Frozen	57,355	25,330	59,525	25,530	3.8	0.8
Butter/Butterfat	240,945	80,945	63,732	23,396	-73.5	-71.1
WMP	105,035	40,459	47,090	23,085	-55.2	-42.9
Milk-Based Drinks	32,770	15,445	37,285	19,189	13.8	24.2
Condensed/Evaporated	42,853	19,731	23,858	14,125	-44.3	-28.4
Cultured/Fermented	49,392	5,684	24,871	6,662	-49.6	17.2
TOTAL*	3,721,078	1,448,714	2,232,814	1,235,521	-40.0	-14.7
* Totals do not include exports of rennet, and casein glues or the value of donated dairy products.						

[2] *Dairy trade statistics shown in this section are derived exclusively from data drawn from the Foreign Agricultural Service Global Agricultural Trade System (GATS): http://www.fas.usda.gov/gats/default.aspx*

FIGURE 1. U.S. Exports of Dairy Products, 2009



Several East Asian countries collectively accounted for about the same percentage of U.S. dairy export value as Canada. Within the East Asian group, countries ranked by percentage of regional export value were China, Japan, Korea and Taiwan. Within this group, China increased its imports of U.S. dairy products six-fold between 2000 and 2009, while Japanese imports increased by 20 percent. Southeast Asian countries, principally the Philippines, Indonesia, Vietnam. Malaysia, Singapore and Thailand, took 12.7

FIGURE 2. Destination of U.S. Dairy Exports, 2009

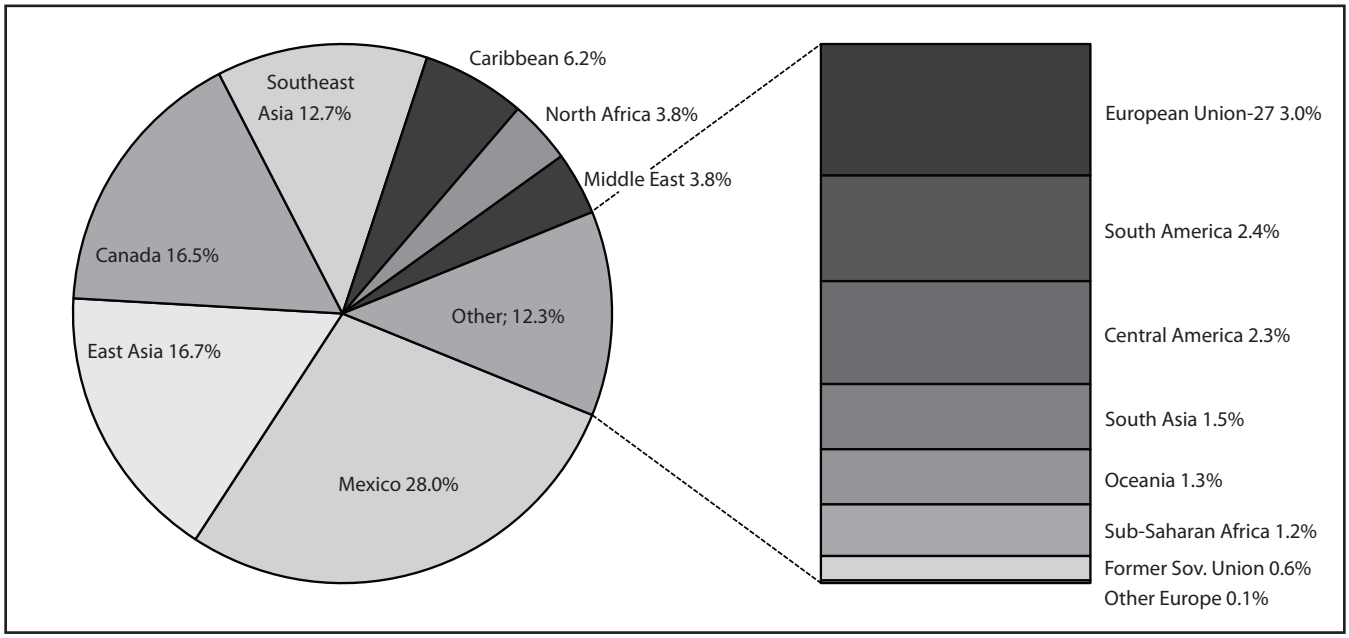


FIGURE 3. U.S. Imports of Dairy Products, 2009

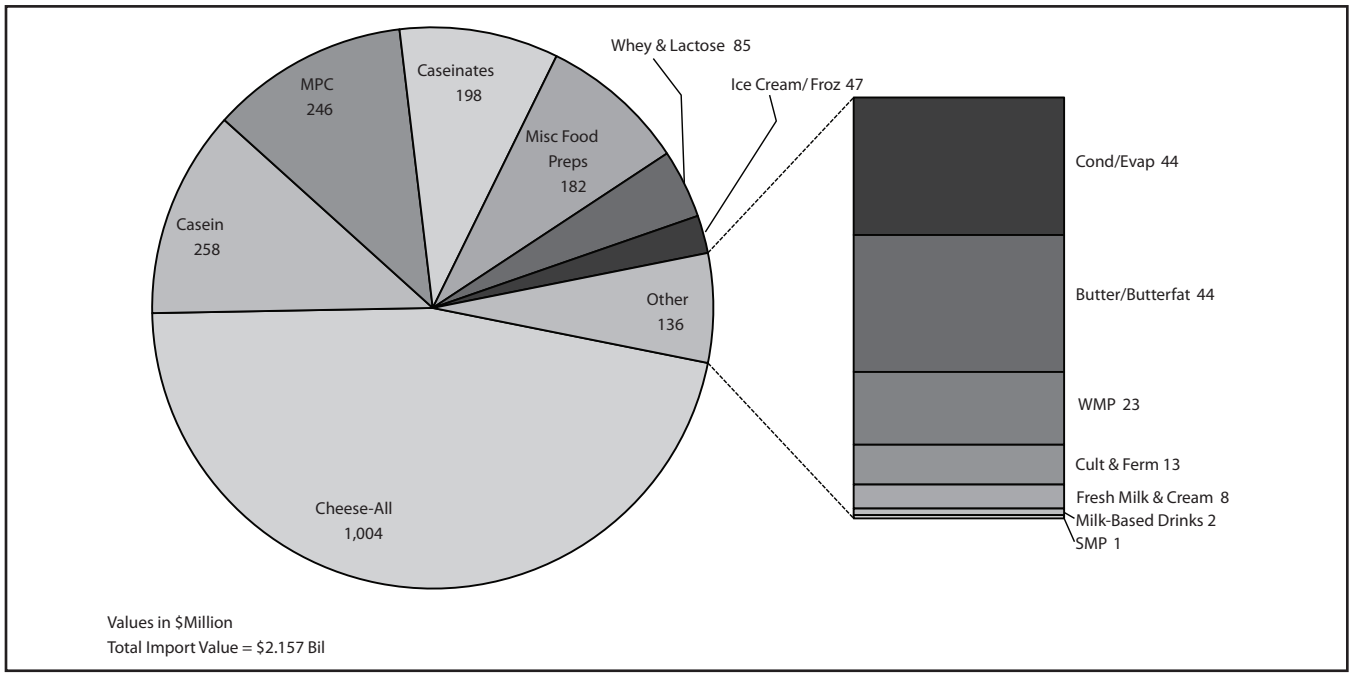


FIGURE 4. U.S. Import Volume: Cheese

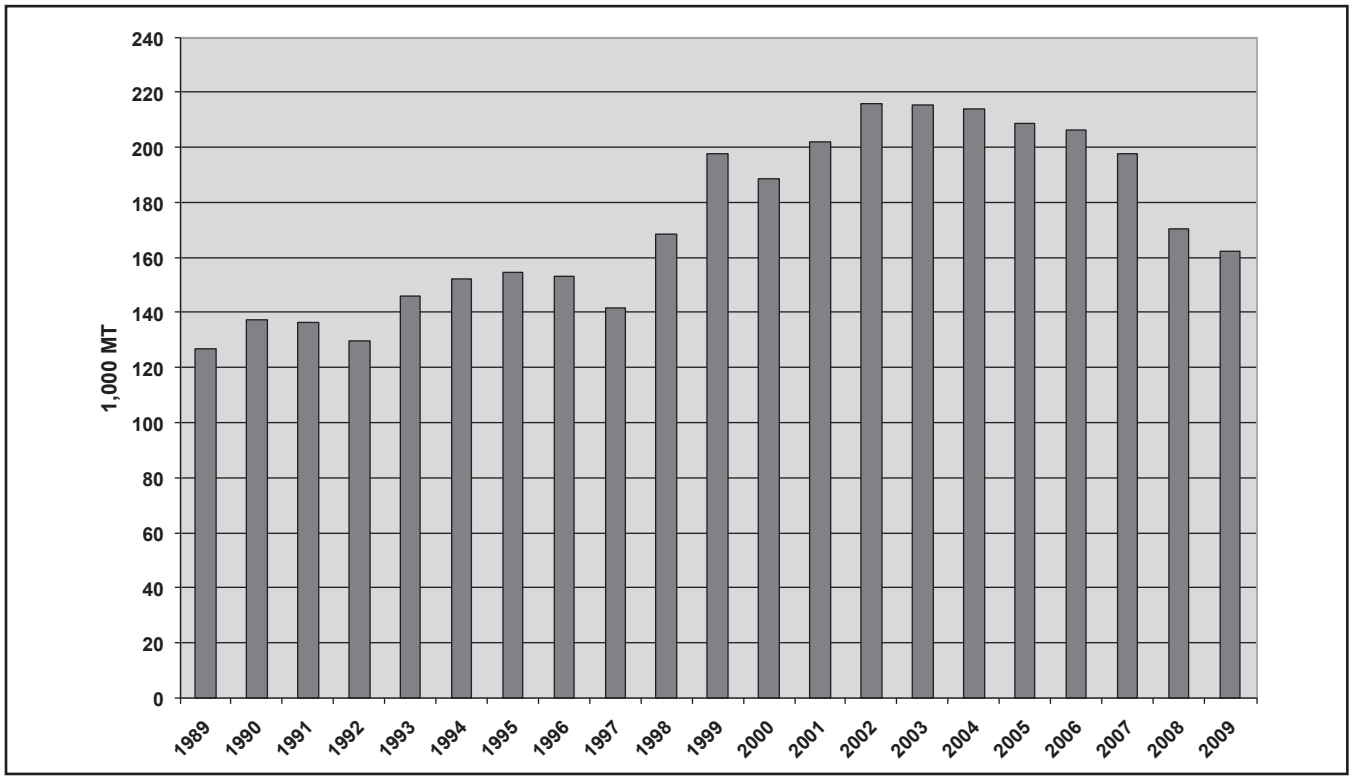
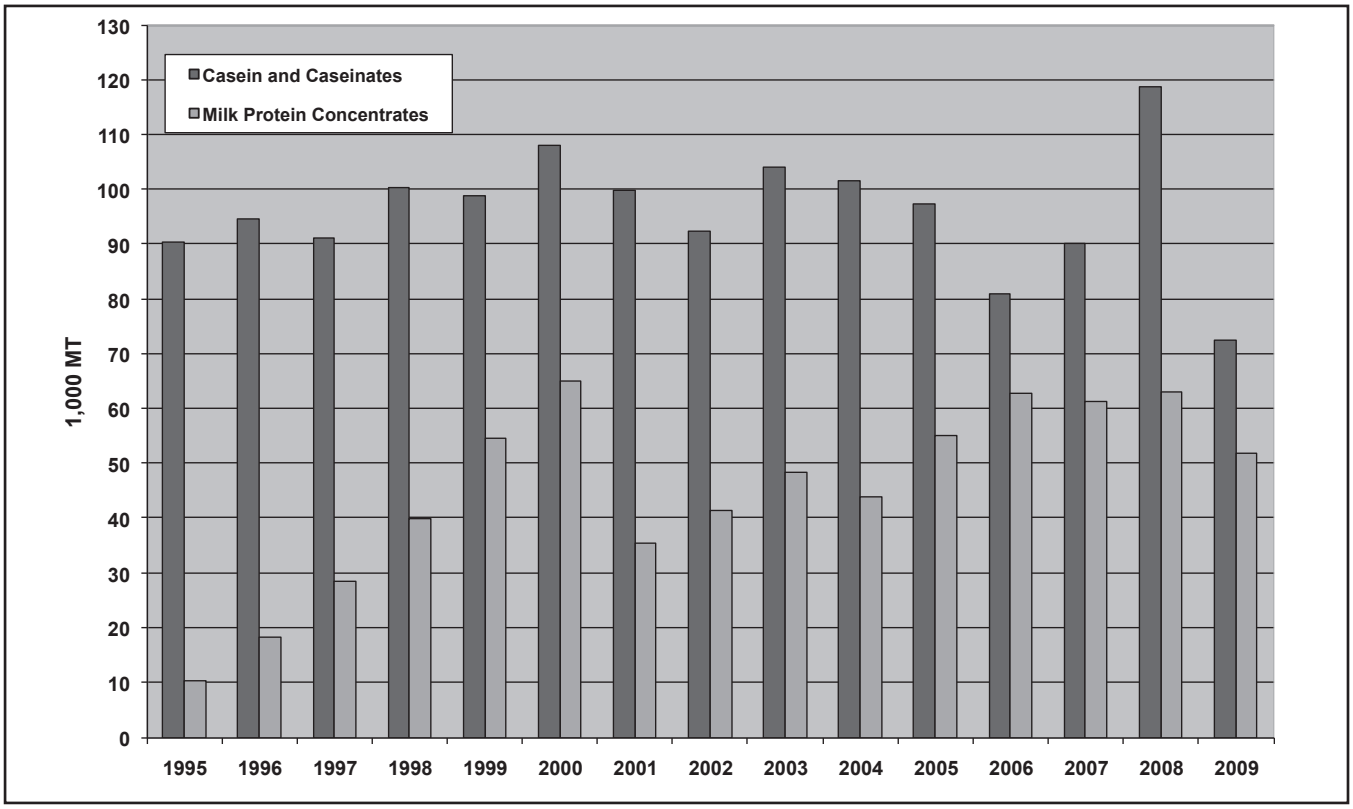


FIGURE 5. U.S. Import Volume: Casein and MPC



percent of U.S. dairy exports in 2009. Over the last 10 years, U.S. dairy exports to Southeast Asia increased from $80 million to $280 million.

Dairy Imports

U.S imports of dairy products were valued at about $2.2 billion in 2009, down $500 million from 2008. As usual, cheese was the largest dairy import item in terms of value, at just over $1 billion. Imports of casein/caseinates and MPC added another $456 million (Figure 3).

The 20-year trend in the volume of U.S. cheese imports is shown in Figure 4. Following implementation of the WTO Agreement on Agriculture in 1995, imports increased from about 150,000 tons to a peak of about 220,000 tons in 2002 and 2003. Since then, the volume of cheese imported into the U.S. has fallen steadily. While several factors likely underlie this trend, an important one is import substitution—U.S. cheesemakers are making more of the cheeses that were once only available from other countries.

Trends in the volume of imports of casein/caseinates and MPC are shown in Figure 5. Casein imports appear to be trending downward in this decade, but with considerable variability. Imports were record high in 2008 and the lowest in 15 years in 2009. MPC imports increased steadily from 1995 through 2000 and then fell off sharply in 2001. MPC imports again trended upward though 2006, but never hit the 2000 high water mark and appear to be trending downward. This is likely because of substantial increases in U.S. production of MPC. In 2009, USDA reported MPC production (for the first time) at about 42,000 MT. Imports were 52,000 MT. It appears that more MPC is being used in the U.S. and that an increasing share of that use is from domestic production.

Measured in value, the European Union (EU) was the largest supplier of U.S. dairy imports in 2009, mostly in the form of cheese (Figure 6). Italy and France accounted for about half of the EU cheese shipments to the U.S.

FIGURE 6. U.S. Dairy Imports, 2009

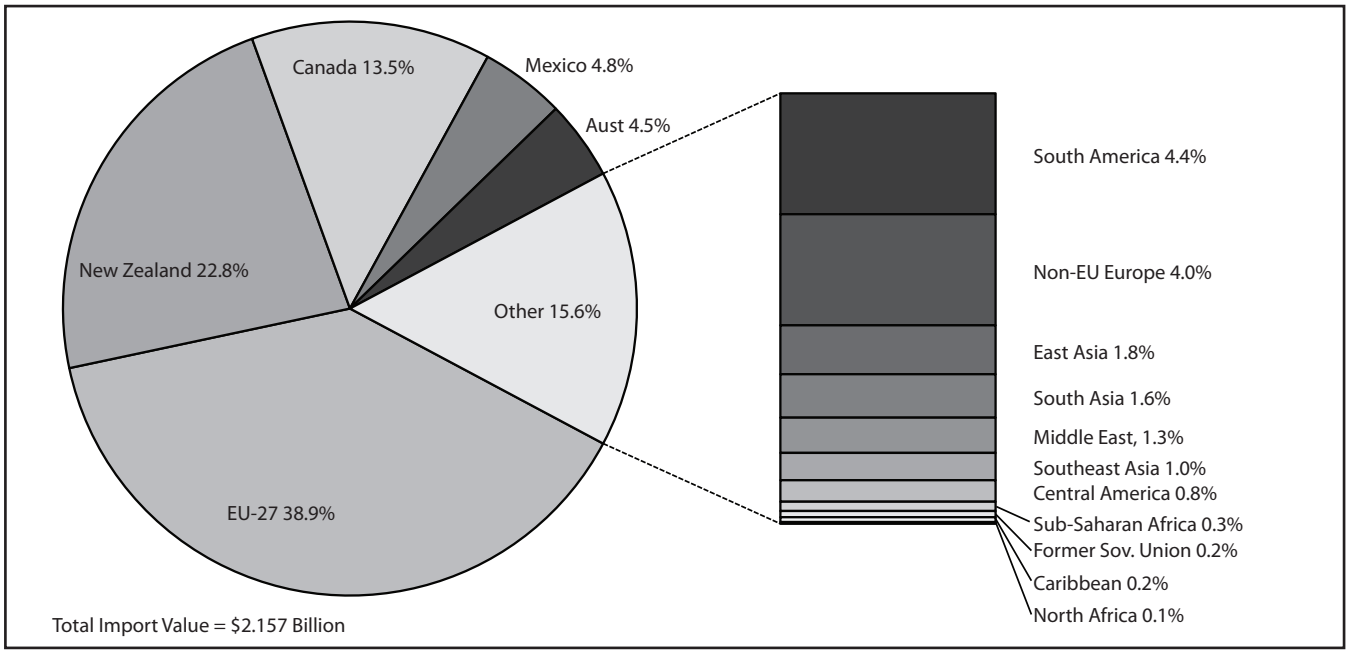
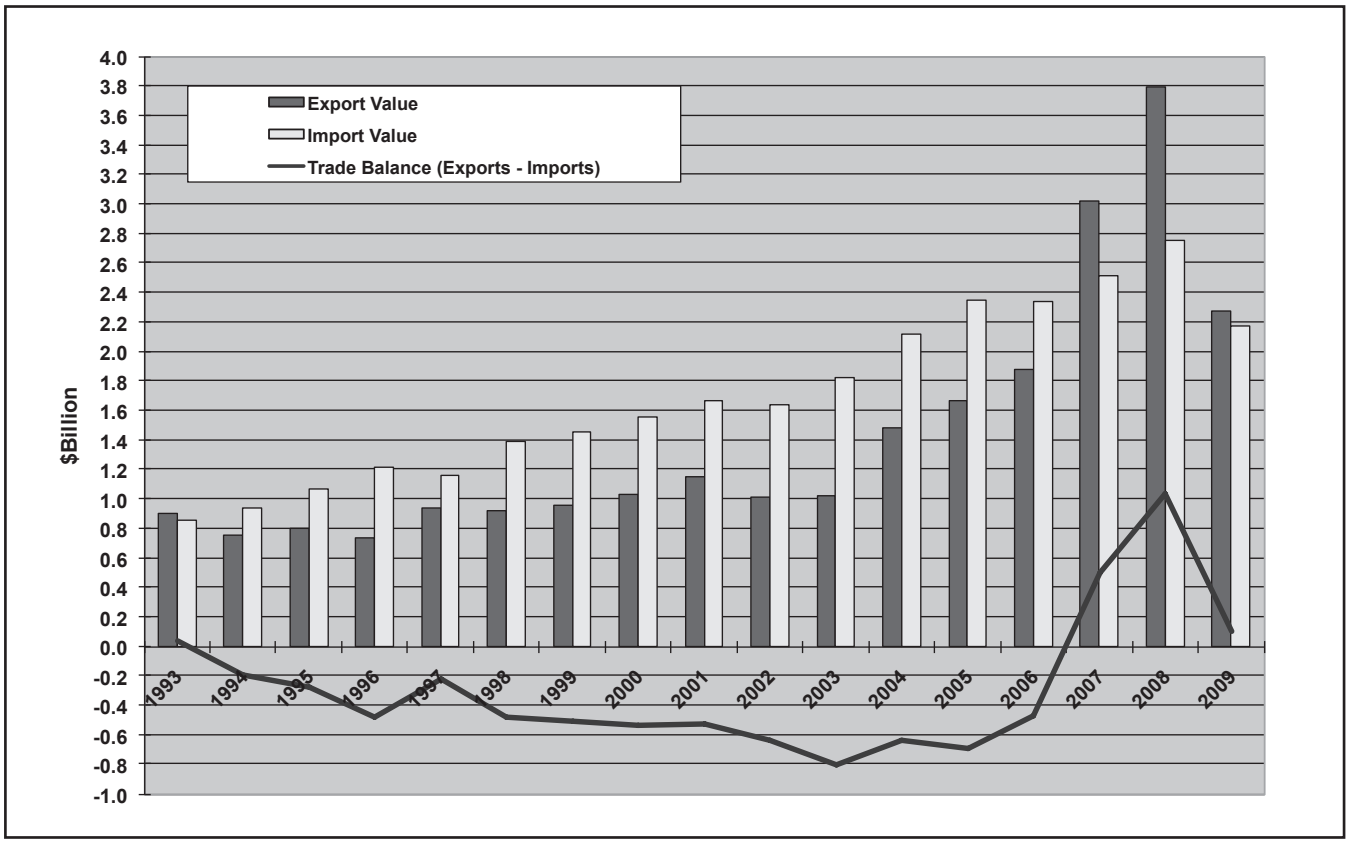


FIGURE 7. U.S. Dairy Trade



New Zealand was the second leading supplier of U.S. dairy imports measured in value. About 80 percent of dairy product shipments from New Zealand were MPC and casein. Canada was in third place, shipping mostly value-added food products containing dairy ingredients.

Trade Balance

The U.S. maintained a dairy trade surplus in 2009, though at $100,000, just barely (Figure 7). To dramatize the drop in export value of $1.5 billion, note that this decrease was substantially larger than the annual value of dairy exports during 1993-2003.

But rather than focus on the fall, it may be more instructive to examine the heights from which the fall occurred. The two-year period, 2007-08, was an anomaly for U.S. dairy exports, characterized by very high world market prices and limited supplies of dairy products—particularly skim milk powder—from U.S. competitors. U.S. dairy export opportunities were unprecedented. From a longer-term perspective, 2009 exports are on trend with 2004-2006, that despite low world market prices in 2009. So it is fair to say that 2009 was a decent year for U.S. dairy exports; 2007 and 2008 were extraordinary years.

Recent Developments

After falling by about two-thirds from their peak levels in 2007 and 2008, world prices for the three major U.S. dairy export items stabilized in mid-2009 and then rose through the end of the year (Figure 8). Since the beginning of 2010, SMP and cheese prices have fallen back some, but whey prices have remained firm at about $1,000/MT. World prices for all three products are above U.S. wholesale prices, indicating profitable export opportunities.

FIGURE 8. World Dairy Prices

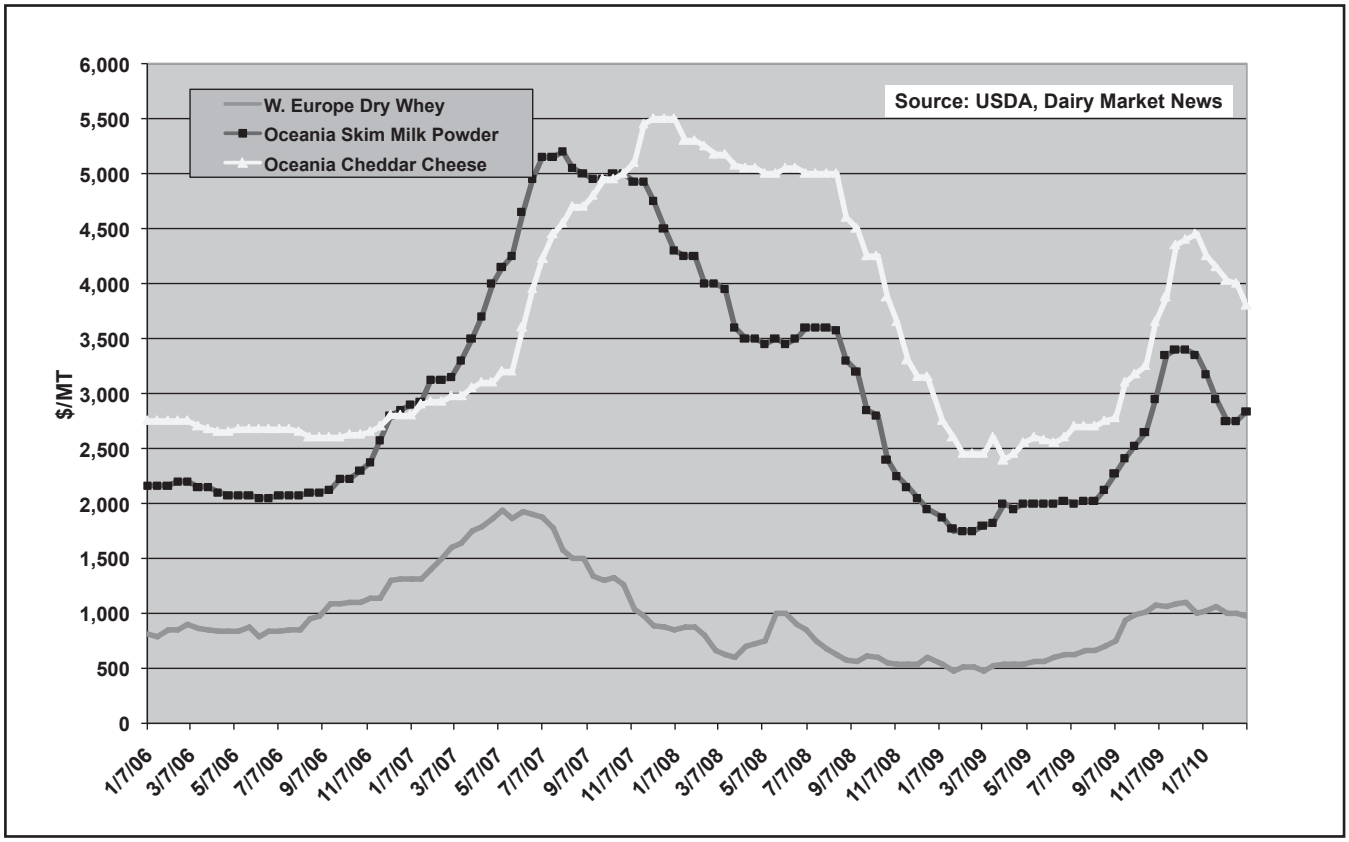
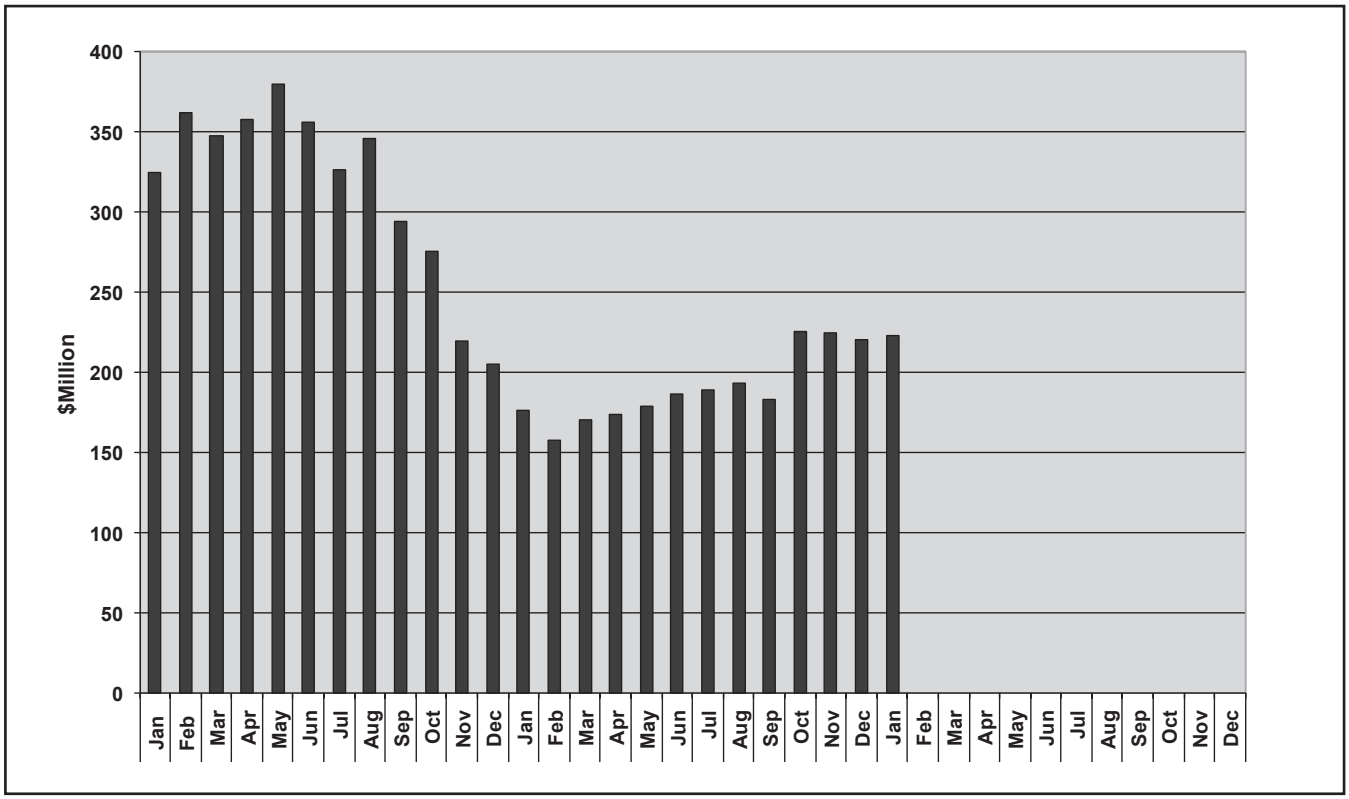


FIGURE 9. U.S. Dairy Export Value by Month



Measured in value, U.S. dairy exports have, indeed, picked up (Figure 9). Export value has been increasingly above year-previous levels since November 2009. In January 2010, export value was 27 percent higher than January 2009.

U.S. Trade Prospects for 2010[3]

Higher world prices alone should pull U.S. dairy export value in 2010 above 2009; by how much depends on export volume. And that depends on the nature of world demand for dairy products and the supply available from major exporting countries.

Global dairy demand will improve over 2009 as recovery from the world-wide economic recession proceeds. The International Monetary Fund (IMF) projects strong rates of growth—especially in comparison to anemic U.S. GDP growth—in 2010 and 2011 in those countries that have recently accounted for most of U.S. dairy exports (Figure 10). Note in particular the real GDP growth projected for Mexico and China, two of the U.S.'s largest customers.

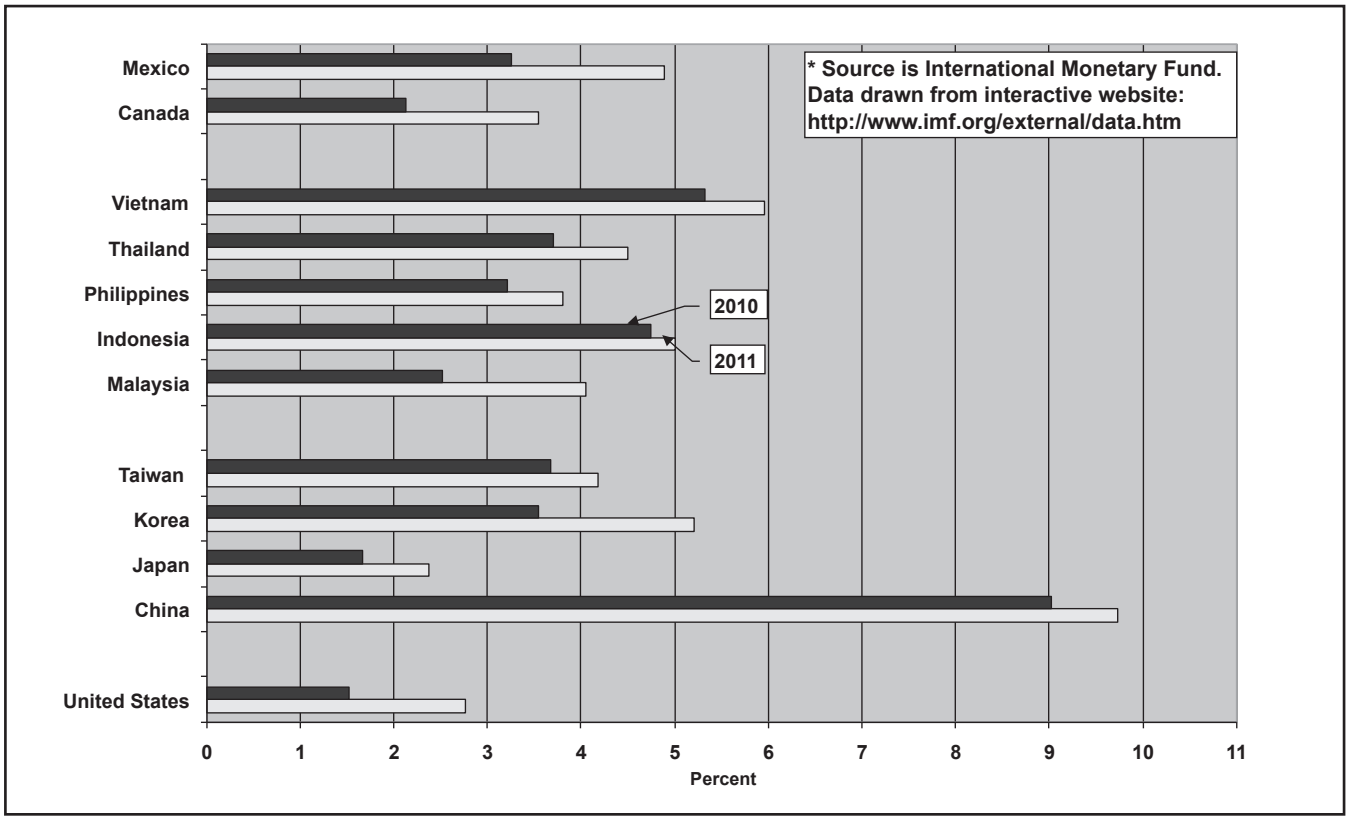
The world milk supply outlook is, as usual, mixed. U.S. milk production in 2010 is expected to be even with or fractionally below 2009. Very low milk prices combined with elevated feed prices yielded losses for most U.S. dairy farmers. Especially hard-hit were western producers, who purchase most of their feed. The financial fall-out from negative cash flow and large equity losses is still uncertain.

New Zealand, the leading world dairy exporter, is expected to show about a 2 percent gain in milk production for its marketing year ending in May 2010, while Australian production will likely be down about 1 percent.

EU milk production in 2010 will about match 2009. EU milk quotas for the marketing year beginning April 1 will be increased 1 percent, but few EU members are expected to utilize the extra quota. Quotas are slated for termination on April 1, 2015.

[3] *The observations in this section represent an amalgamation of outlook information from several sources, but rely heavily on [10].*

FIGURE 10. Projected Growth in Real GDP*



After falling sharply below trend in 2009, China's milk production is expected to jump by 10 percent in 2010. This will still leave Chinese milk production 4 million MT under its peak of 35.3 million MT in 2007 and well under production necessary to meet growing demand for dairy products.

In South America, Argentina well likely expand milk production marginally. Brazil could increase output by 5 percent, continuing its rapid five-year rate of growth.

Adding to dairy products manufactured from 2010 milk production are carryover stocks from 2009. While commercial stocks are not oppressive, the EU and the U.S. are holding large public stocks from intervention purchases made last year. The U.S. has only nonfat dry milk in storage, and that stock is dwindling rapidly with allocations to special uses. But at the end of 2009, the EU held about 250,000 MT of skim milk powder and 75,000 MT of butter in storage [1]. These stocks "overhang" the market in the sense of limiting upward price movements.

Considering the aggregate of world dairy demand and supply factors, the outlook for U.S. exports is quite positive. USDA is currently (March 2010) forecasting a 12 percent increase in the volume of U.S. exports (using 60/40 Skim/Fat milk conversion to milk equivalent) [11]. December 2009 USDA product forecasts showed 2010 cheese exports up 7 percent, butter exports up almost 100 percent, and nonfat dry milk exports up 16 percent [10]. Since export prices should remain above 2009, these projected increases in export volume suggest even larger gains in export value.

The bottom line: expect U.S. dairy export value in 2010 to be in the range of $2.7-3.0 billion.

Trade Policy Outlook for 2010

Little has changed in the past year regarding the dairy trade policy outlook. Therefore, this section will be brief. In summary, trade policy initiatives remained firmly on the back burner in the U.S. and in many other major trading nations in 2009. U.S. trade policy

initiatives are likely to remain subdued in the run-up to the 2010 elections.

It is no surprise that few trade policy expansion initiatives occurred in 2009 and early 2010. In a world battered by recession, global trade fell by 12 percent in 2009, the sharpest decline since the end of World War II [7]. In this economic environment, many governments and trade policy officials were more concerned with helping their countries weather the global financial crisis and protecting domestic markets than with trade expansion efforts.

Fortunately, protectionist measures taken by governments during the recession were less draconian than forecasted. According to the World Trade Organization (WTO), protectionist measures—while still a problem—began to decline in the fourth quarter of 2009 [9].

Fading Hopes for the Doha Round of WTO Negotiations

New thinking has emerged in government and trade policy circles that could affect U.S. dairy trade. This is because negotiations for the WTO Doha Round, which began in 2001, appear likely to wither away and be abandoned.

Why the pessimism about the Doha Round? The Doha Round trade ministerials, mini-ministerials and negotiating sessions held in Cancun, Mexico (2003), Geneva, Switzerland (2004), Paris, France (2005), Hong Kong, China (2005), Geneva, Switzerland (2006), Potsdam, Germany (2007), and Geneva, Switzerland (2008) all ended in collapse or stalemate. This is not an enviable record. And there is scant evidence that renewed negotiations will be more successful. Thus, realism regarding the dismal prospects for the Doha Round has emerged, and new options are being considered.

From the U.S. perspective, market access for agricultural products has been a big sticking point in the Doha Round negotiations. Recall that the 2008 Doha Round negotiations collapsed partly because U.S. negotiators objected to special safeguards and differential tariff arrangements insisted upon by India, China and certain other nations. The special safeguards would allow tariff increases in India, China, and other developing nations to protect farmers from import surges or other developments that push down prices. U.S. negotiators argued that the bar was set too low by India and China and would allow tariff increases after small price reductions such as those that occur when prices fall seasonally by larger than normal amounts.

Many WTO members claim that the doubtful future for the Doha Round WTO negotiations is caused partly by U.S. foot-dragging. Critics correctly point out that when the U.S.—a major player in trade policy—declines to push for reform, nothing much of substance happens in WTO trade negotiations.

The Obama Administration has shown little enthusiasm for pushing for rapid completion of the Doha Round. Many in the U.S. agricultural sector were disappointed with gains in market access achieved after completion of the Uruguay Round WTO agreement in the mid-1990s. Accordingly, after previous negotiating sessions for the Doha Round collapsed, representatives of many U.S. agricultural organizations were heard to utter: "No deal is better than a bad deal." Officers of both agricultural and non-agricultural businesses also questioned the need for a new WTO agreement, pointing out that before the 2008-2009 global recession, international trade had continued to expand in the absence of a new WTO agreement. Finally, U.S. labor unions fear that member job losses might accompany a Doha Round agreement. With such a weak backdrop of support, there is little incentive for the Obama Administration to help move the Doha Round WTO negotiations off the back burner.

Moreover, even if the U.S. favored pushing for rapid completion of a Doha Round agreement, the Obama Administration may lack the means to bring about this result. Specifically, the Administration lacks the Trade Promotion Authority (fast-track negotiating authority) needed to bring any Doha Round WTO Agreement to an up-or-down vote by the U.S. Congress with no modification of the provisions. Many other trading nations fear that in the absence of fast-track negotiating authority the Congress will tinker with agreed up provisions. Thus, they are reluctant to complete negotiations with the U.S. if the President lacks fast-track negotiating authority.

U.S. reluctance to vigorously support completing the Doha Round does not mean that the U.S. attaches little importance to trade expansion. Indeed, President

Obama in his State of the Union address on January 27, 2010, set a goal of supporting two million new American jobs by doubling agricultural and non-agricultural exports in the next five years [5, 6]. The export expansion is to be achieved partly via efforts of key federal agencies (USDA, USTR, Commerce, Small Business Administration, Export-Import Bank and other agencies) that will participate in a National Export Initiative.

Of course, it may be premature to write off the Doha Round WTO negotiations as doomed to failure. Death sentences have been pronounced before for other GATT (predecessor to the WTO) negotiations only to see those earlier negotiating rounds resurrected and agreements reached. Moreover, the Doha Round of multilateral negotiations has determined champions. Pascal Lamy, WTO Director-General, continues to point out the substantial advantages of completing the Doha Round and encourages trading nations to try once more to reach agreement. Lamy noted, in particular, that "…the multilateral trading system has proven its sturdiness as a bulwark against runaway protectionism (during the recent recession) [7]." In addition, Ambassador David Walker of New Zealand, chairman of agricultural negotiations for the Doha Round, pointed out that useful consultations were carried out in early February, 2010 on remaining Doha Round issues relating to the three pillars of agricultural trade liberalization; namely export subsidies, trade-distorting internal support for agriculture, and market access [12].

The expertly-staffed Food and Agricultural Trade Policy Council described the status of Doha Round WTO negotiations in late 2009 as follows [2, p. 11]:

> *While governments were not able to conclude the Doha Round in 2008, substantial progress was made in the agricultural agenda. Agreement has been reached to completely eliminate all forms of export subsidies and to significantly reduce trade distorting domestic support…On market access the situation is less satisfactory. Hope for sweeping across the board tariff cuts has been replaced by a realization that the outcome will be more complex. A number of flexibilities have been introduced into the negotiating texts.*

The Trade Policy Council describes effects of the controversial flexibilities in these terms: "The acceptance of sensitive products; special agricultural safeguard; special safeguard mechanism for developing countries as well as 'tailor-made' provisions for exemptions for a number of countries, both developed and developing, will allow substantial deviations from the full implementation of the tariff reduction formula [2, p. 11]." The Trade Policy Council concluded that this complex array of safeguards and exemptions will "…seriously reduce, and in many cases prevent, real improvements in market access now and in the future if they become permanent fixtures of the Agreement on Agriculture [2, p. 11]." The scope of the safeguards and exemptions suggests that these provisions will continue to be an important sticking point for U.S. agricultural negotiators under the Doha Round.

There is clear recognition that bilateral trade agreements and regional trade agreements (RTAs) will proliferate as a result of the uncertain future and possible failure of the Doha Round. Globally, hundreds of these agreements already exist and many more are under consideration. The effectiveness of one RTA, the North American Free Trade Agreement (NAFTA), for expanding U.S. dairy exports to Mexico is well known. By reducing Mexico's tariffs on U.S. dairy imports to zero, the NAFTA has helped to make Mexico the largest market for U.S. dairy exports, a market that accounted for 26 percent of the total value of U.S. dairy exports during 2004-2008 [4].

U.S. dairy firms are not the only beneficiaries of a free trade agreement entered into by Mexico. Mexico in 1999 entered into an agreement with Chile that provided lower tariffs for Chilean exports of dairy products to Mexico [4]. Fonterra of New Zealand benefited from this agreement since a Chilean firm owned by Fonterra sells cheese and other dairy products to Mexico under preferential tariff terms.

In noteworthy recent negotiations, the European Union (EU) in early 2010 entered into negotiations with Vietnam, a country with 86 million people and a $100 billion economy [8]. The EU hopes to expand sales of European cheeses, wine, pharmaceuticals and cars to Vietnam under the agreement.

In an environment where a Doha Round WTO agreement is unlikely to be reached the U.S. may need to be more aggressive in negotiating bilateral and RTAs if the country is to expand export markets for

agricultural and non-agricultural products. President Obama and U.S. Trade Representative, Ron Kirk, are of course aware of this competitiveness issue. In his 2010 State of the Union message, President Obama spoke of bringing bilateral trade agreements already negotiated with Colombia, Panama, and South Korea to the U.S. Congress for ratification. Noting the importance of these agreements to U.S. agricultural exports, Trade Representative Kirk quoted a U.S. Farm Bureau Federation estimate showing that "…U.S. farm exports to Korea, Colombia, and Panama will increase annually by almost $3 billion after full implementation of these FTAs, with gains spread across a wide range of U.S. agricultural products [6]." However, it is not clear whether long-standing sticking points relating to these agreements will be resolved in time to bring these agreements to the Congress for a vote in 2010.

New Thinking on Trade Agreements

The International Food and Agricultural Trade Council claims that a successfully concluded Doha Round still offers the greatest potential for agricultural trade reform at this time [2]. However, the Council adds that the slow pace of the Doha Round negotiations has led to calls for alternative options. Briefly, the complex alternative options considered by the Council were as follows:

- Sectoral Negotiations. This item calls for a return to the original notion of having the WTO serve as a permanent negotiating forum that conducts a series of sectoral negotiations. This option would provide separate negotiations for agricultural products and non-agricultural products. Among other things, this option might simplify negotiations.

- Plurilateral Agreements. These agreements negotiated by a subset of WTO members would go into effect without the agreement of the entire membership. For such negotiations to be successful, they must include most of the important nations that have an interest in a particular rule or product.

- Bilateral and Regional Trade Agreements (RTAs): In order to have a significant impact on the multilateral trading system, bilateral and regional agreements should be between large trading entities. This, the Council argues, would encourage others to join or form other mega-RTAs. The Council adds that WTO members also should consider other options to better streamline RTAs in the WTO system, i.e.,"multilateralizing" RTAs.

- Improve the WTO Dispute Settlement Procedures: Important disputes were settled under the current WTO machinery relating to the Canadian dairy export subsidies, EU sugar, and U.S. cotton. If the Doha Round cannot be successfully completed, it may be useful to explore ways to make the dispute settlement procedure more user friendly, especially for developing countries.

The alternative options presented by the Council show the immense complexity of developing partial replacements for the current WTO multilateral system. Furthermore, it is far from clear whether trading nations would agree to adopt the alternative options. Indeed, trade officials might readily conclude that it is more feasible to try to reach agreement on the Doha Round than to pursue one or more of the alternative options considered by the Council.

However, making the WTO dispute settlement procedure more user friendly appears to be a worthy idea. Currently, it is massively expensive and time-consuming for countries to employ the WTO dispute settlement machinery to settle trade disagreements. For example, it took from October 1997 until May 2003 to move the Canadian dairy export subsidy dispute relating to Canada's dairy pricing system from the initial U.S.-New Zealand WTO challenge through the final appeals [3]. Trading nations probably find that it is economically feasible to challenge only the most flagrant and damaging violations of WTO rules under the current dispute settlement system.

The bottom line: The lack of progress on agricultural trade reform is not good news for the efficient and increasingly export-oriented U.S. dairy industry.

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