

IPC Position Paper No. 2

Dairy Policy in the Post-Uruguay Round Era

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The views expressed in this position paper are those of the members of the International Policy Council on Agriculture, Food and Trade.

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Foreword

The dairy and sugar sectors comprise two of the principle agricultural sectors left largely untouched by the Uruguay Round Agreement of GATT when it was concluded in December, 1993. These shortcomings inspired the International Policy Council on Agriculture, Food and Trade (IPC) to develop recommendations for bringing dairy and sugar policy into line with the reforms being implemented in other agricultural sectors.

Consequently, the IPC planned a series of consultations in support of position papers on dairy and sugar policy reform. This paper is the result of the deliberation of the IPC's dairy task force; the sugar paper is being published separately. The first such meeting of the dairy task force took place at the IPC's 14th Plenary Meeting and Seminar in Sydney, Australia in October, 1994, at which time the IPC met with industry representatives to determine the primary challenges facing the dairy sector in the post-Uruguay Round era.

IPC member Aart de Zeeuw prepared the first draft of the position paper which was presented at a Milk Policy Symposium hosted by the International Dairy Federation (IDF) in Vienna, Austria in November, 1995. The paper focused on the policy reforms necessary to keep the sector healthy in the future and was well received by symposium participants.

Then, in April, 1996, the IPC co-hosted a roundtable discussion with the International Federation of Agricultural Producers (IFAP) in Versailles, France, to discuss the paper and the future direction of dairy policy. Participants in the roundtable included farm organization leaders from Australia, New Zealand, Denmark, the United States and Canada, as well as IFAP and IDF officials.

Finally, at the IPC's 17th Plenary Meeting May 12-14, 1996, in Brussels, Belgium, the draft position paper was presented to a full meeting of the IPC. The Council membership endorsed the paper's conclusions and agreed to issue the document as an official IPC Position Paper.

The present text is therefore the result of two years of global research and consultation by the membership of the International Policy Council on Agriculture, Food and Trade. The project and the resulting paper would not have been possible without the generous support of the organizations listed on the preceding recognition page. In particular, the IPC would like to thank IPC Member Aart de Zeeuw for overseeing the consultations over the past two years and Aart de Zeeuw and IPC Secretary Ann Tutwiler for writing and editing the final paper.

Introduction

The Uruguay Round Agreement is the first multilateral trade agreement in history to extensively cover the agricultural sector. For the first time, an internationally binding trade agreement places limits on export and domestic subsidies, and increases market access for agricultural products. However, not all products are affected equally by the Uruguay Round Agreement. It is true that most countries have agreed to reform their commodity policies; but the dairy sector itself was left largely untouched because of the level and nature of the support afforded that sector.

The International Policy Council on Agriculture, Food and Trade believes that the dairy sector must begin to address the trade and policy challenges that lie ahead as the results of the Uruguay Round are consolidated and built upon in subsequent trade agreements. This paper examines the policies and markets in key dairy producing and consuming nations, and offers some recommendations about how such policies must be revised in order to meet these future challenges.

The Uruguay Round Agreement

Until the Uruguay Round, domestic agricultural policies were virtually untouched by world trade negotiations. In the past, countries have tried to protect farmers' incomes through various combinations of direct payments and guaranteed price policies, made possible with the help of border measures such as variable levies, quantitative restrictions, and other non-tariff barriers and export subsidies. For governments increasingly beset by budget constraints, border measures are the least expensive option (the most expensive being direct income support) for protecting farm incomes.

However, the resulting high price guarantee policies led many countries in the developed world to overproduce to such an extent that long-term market distortions occurred. The dumping of these surpluses on the world market resulted in low and sharply fluctuating world prices, often leading to trade wars and considerable cost to governments. Equally, policies to sharply limit domestic supplies and/or exportable surpluses in order to raise prices and lower budget outlays increased the cost of raw materials for domestic processing and livestock industries in many countries.

Studies have shown that, usually, greater trade liberalization will lead to higher and more stable world prices. But how can countries achieve their domestic objectives for the agricultural sectors while simultaneously liberalizing international trade?

To bring agriculture fully into the World Trade Organization, the Uruguay Round Agreement imposed disciplines on many policies that have historically been used to protect farmers and farm income, such as import quotas, variable levies, and export subsidies. Certain types of income support to farmers are subject to no restrictions. Under the agreement, non-trade distorting direct income supports can be used to help farmers to

survive more open competition and address the social, political, and environmental concerns facing individual countries. Specifically, the Uruguay Round Agreement on Agriculture requires:

- *Border protection* measures to be converted to tariffs and a reduction in those tariffs by an average of 36 percent.
- *Minimum market access* of 3 to 5 percent of internal consumption to be provided for each product.
- *Internal support* levels to be reduced, according to category. All non-trade-distorting supports, including support per hectare and/or animal, were placed in the so-called “green box,” and all the trade-distorting supports were placed in the so-called “amber box.” The “blue box” covered the United States system of deficiency payments and the European Union’s direct income payments.
- *Export subsidy* outlays to be reduced by 36 percent and subsidized volume by 21 percent per product or group of products.
- *Sanitary and Phytosanitary regulations* to be subject to scientific criteria so that they can no longer serve as disguised protectionist measures.
- *Special and differential treatment* to be retained for developing countries.

In the short-term, the agreement’s effect on international trade generally will be limited. This is because, during the chosen reference periods (1986-1990), border protection measures—variable levies, tariffs, and export subsidies—were much higher compared with the 1990s (when lower world market prices have prevailed). Moreover, many countries took deliberate steps to raise their new tariff levels above the equivalent level of border protection afforded by quotas. Consequently, for many products, even a 36 percent reduction in tariffs for the main products does not result in significantly greater access opportunities. Unless countries choose to further reduce tariffs prior to the next round of global trade negotiations, the only real possibility for more market access during the implementation of the Uruguay Round rests in the minimum and current access commitments.

The choice of the 1986-1990 base period also limits the impact of the 20 percent reduction in internal supports. For similar reasons, the budget reduction of 36 percent on export subsidies will have little impact on most commodities, although it will have a significant impact in a few cases. For other products, the volume reduction of 21 percent will have a greater impact.

The impact of the agreement is further limited by the possibility provided to aggregate commodities, a sizable “green box”, the creation of the “blue box”, flexibility in the implementation process, exemption from tariffication in some cases (e.g., rice in Japan and South Korea), the safeguard clause, and special arrangements for developing countries.

Over the longer term, however, the agreement will prove to be quite significant. It represents the first time that disciplines have been imposed on agricultural policies. Over

time, the agreements on market access and export subsidies will have an effect. The tariffication process provides the basis for future negotiations. The Uruguay Round Agreement obliges governments in the developed world to change their agricultural policies in such a way that gradually more open competition on the domestic and world markets becomes possible. Moreover, policy changes initiated by the agreement are likely to be built upon in future international agreements. Over time, therefore, these changes—as well as pressures from national budgets, new technologies, industrial consolidation and environmental concerns—will force countries to reform their agricultural policies.

The World Dairy Market

The world's major dairy producers are the European Union (110 MMT), the United States (69 MMT), and the countries of the former Soviet Union (64.5 MMT) (see annex 1).

Total world milk production declined in the late 1980s and the 1990s because of the quota system in the EU and the collapse of production in the countries of Central and Eastern Europe due to the breakup of state farms and the slaughter of dairy cattle in the face of rising feed prices. The production increases witnessed in Australia, New Zealand, Japan, the US, and some developing countries were insufficient to compensate for this drop in production.

Because of the self-sufficiency policies pursued by the major producing countries, only 6 percent of global milk production (520 MMT) is traded on world markets. However, a greater proportion of manufactured milk products enters world trade (e.g., 11 percent of butter, 7 percent of cheese, 26 percent of skimmed milk powder and 47 percent of whole milk powder). (It is important to point out that most trade in the dairy sector is in products, not milk. The necessary conversion of trade figures into milk equivalents obscures a very complex trade picture.)

The EU still dominates world dairy trade, but its share of the export market is diminishing (from 55.5 percent in 1990 to 48.5 percent in 1994; see annex 2). As a result of the Uruguay Round Agreement to reduce the volume of subsidized dairy exports, this percentage will continue to decline.

The share of the export market of Australia, New Zealand and the US grew significantly in this same period. The US now accounts for 9 percent of the world market (versus 1.4 percent in 1990), Australia accounts for 12 percent (versus 10 percent in 1990), and New Zealand accounts for 27 percent (versus 20 percent in 1990). Meanwhile, the portion of the export market shared by the EFTA (then Norway, Sweden, Finland, Austria, and Switzerland) countries declined from almost 10 percent in 1990 to 6 percent in 1994.

A significant share of traded dairy products (about 35 percent) falls under bilateral import quota arrangements among the major Western economies and Central and Eastern Europe. These arrangements primarily cover cheese and butter trade. Exports to Central and Eastern European countries are currently of significant size, but this should diminish

once the dairy sectors in these countries recover. It is not expected that these import quota arrangements will change very much over the next five years.

Outside of the above arrangements, the major import markets for dairy products are the Middle East (10 percent), Central and South America (10 percent), North Africa (10 percent), and Southeast Asia (20 percent). Most of this trade is in skimmed milk powder.

For the medium-term, the OECD predicts growth in demand for dairy products in Southeast Asia and South America, small growth in Eastern Europe (depending on the pace and extent of economic recovery), and stabilization in the OECD countries as a whole. World demand is expected to expand yearly by 2.5 percent between 1995-2000.

It is interesting to note how the various exporting countries' export shares have developed in Southeast Asia and South America. Annex 2 shows the decline in EU exports to Southeast Asia (from 47 percent in 1990 to 40 percent in 1994) and the strengthened position of Australia (21 percent to 29 percent) and New Zealand (26 percent to 28 percent). The development of the export shares in the South American markets is equally remarkable. Again, the EU has declined (from 57 percent to 51 percent), mainly in favor of the US (2 percent to 8 percent) and Australia (4 percent to 12 percent). These shifts indicate that the EU's deteriorating position on the world market is due to its diminishing shares in the growing markets of Southeast Asia and South America.

Concerning the world market price, the OECD expects higher prices as a result of slower growth in milk production in OECD countries, decreased export subsidization, and increasing demand for all dairy products except butter.

The Impact of the Uruguay Round Agreement on the Dairy Sector

The impact of the Uruguay Round Agreement on the dairy sector varies from country to country, and indeed from product to product within the dairy sector itself.

Tariffication of import barriers will not force the US, the EU, Japan, Canada, and other countries with a dairy policy based on guaranteed prices to change the level of protection afforded their dairy sector in any fundamental way. Even a 36 percent cut in the sometimes very high tariffs—based on low world market prices during the reference periods—will not lead to substantially greater import possibilities. Moreover, most of the aforementioned countries opted for the possibility of the lowest allowable level of tariff cuts (minimum 15 percent) in their dairy sectors: Japan, 15 percent for all products; the US, 15 percent for all products; Canada, 15 percent for all products; and the EU, 20 percent for butter and 36 percent for other products.

The only real possibility of more access to markets under the existing Uruguay Round Agreement therefore lies in the minimum access commitment of 3 percent, expanding to 5 percent in 2001 (in Japan to 8 percent). Because of its unique marketing structure, Japan has committed to maintain current access for 137,000 metric tons of milk

equivalents, plus private imports for the school lunch program, infant formulas, and animal feed.

The EU must allow an additional 37,000 tons of butter (from 50,000 to 87,000 over the life of the agreement), 114,000 tons of cheese, and 28,000 tons of milk powder (OECD). The US must import an additional 6,700 tons of butter, 4,700 tons of milk powder, 30,000 tons of cheese, and 5,600 tons of butter oil. The agreement eliminated US Section 22 quotas, and the import levels that were prescribed under those quotas must be expanded. Japan already imports enough to cope with its higher (8 percent) minimum access commitment. Only a 7 percent increase in the import of cream and yogurt is required.

Thus, in general, the growth of import opportunities in the EU, the US, and Japan is small and has not had a significant impact on the world market. However, for specific products, notably butter, the growth in import opportunities in the EU and the US is significant.

The agreement's export subsidy commitments will have a greater impact on the international market. The commitment to reduce these subsidies by 36 percent of budget outlays and by 21 percent of subsidized volume will certainly improve the level of world prices.

Compared with 1994, the volume of subsidized exports of all EU dairy products (except butter, butter oil, and skimmed milk powder) must be reduced by a percentage, varying between 20 and 34 percent (the EU already considerably reduced the export volume of butter, butter oil, and skimmed milk powder between 1986 and 1992).

In addition, the budget cuts for the export of cheese and other products (except butter and milk powder) range from 27 percent to 39 percent compared with 1994, depending on the product. However, due to the cuts in export refunds in recent years, this budget commitment will cause few difficulties, provided present strong world prices for dairy products continue.

The US is obliged to reduce its subsidized volume of butter exports by 40 percent and milk powder by 50 percent, and its budget outlays for these products by one-third compared with 1995. In 1995, the US began increasing its export subsidies on skimmed milk powder through the use of the Dairy Export Incentive Program, principally into Asian markets.

The Evolution of National Policies, Post-Uruguay Round

Canada

The Canadian dairy sector has operated under a system of supply management for 25 years. Under a national policy, its administration is shared between the Provincial and

Federal governments. Based on an annual national quota, and a target price for milk, the provinces distribute quota among producers. The federal Canadian Dairy Commission establishes support prices for butter and skimmed milk powder, and with the support of a federal subsidy, manages the supplies of products to meet the target price. A producer levy was used to finance exports of excess dairy products, but that levy is being phased out as a result of the Uruguay Round. Import quotas were applied under GATT Article XI.

Under the Uruguay Round Agreement, import quotas were replaced with tariff quotas and high tariff equivalents. The in-quota tariffs are being reduced by 36 percent and the above quota tariffs by 15 percent. The system of export levies was replaced by a mechanism to allow surplus products to be exported at world prices on an optional basis. Hence neither the Uruguay Round Agreement, nor the Canada-US Free Trade Agreement, nor the NAFTA, have significantly affected the import protection afforded the Canadian dairy industry.

However, the US has challenged the status of the new WTO tariffs, claiming that NAFTA supersedes the WTO Agreement, and that the tariffs should be removed completely by 1998. A panel decision is expected after mid-1996.

Although total Canadian milk production has remained at about the same level since the supply management system was implemented, the number of dairy farms has declined significantly, at a rate comparable to US experience. However, average herd size and yields have remained lower in Canada than in the US. In addition, provincial market shares have remained stable in Canada while US dairy production has shifted to the south and west.

Supply management is the key policy affecting the Canadian dairy industry. Farmers and industry alike are in favor of continuing supply management. In the short term, they are able to do so because the minimum tariff reduction of 15 percent will generate no new imports, and they are willing to accept a lower price for exported products.

Whatever the outcome of the US trade challenge, there will be pressure to adjust the system. The 1995 federal budget announced a 30 percent reduction in the direct subsidy to the dairy industry over the next two years. The subsidy will be eliminated in 3 years, starting in 1997. The regulation of the fluid and industrial markets is moving closer together. A single quota for fluid milk (including processing milk) is used by several provinces. The net effects of these and other changes is likely to be a continuing shift towards a more integrated and market responsive sector. This will allow improved efficiencies to emerge and enable the Canadian industry to meet competition on a progressively more open market basis.

United States

The US dairy industry is becoming increasingly competitive. Milk production in 1994 and 1995 grew faster than the average historical growth rate of 1.2 percent per annum. This trend is likely to continue as the dairy industry expands into new, sparsely

populated areas, and as farmers find other ways to reduce their costs of production. Like the hog and poultry sectors before it, dairy farms are beginning to take advantage of economies of scale. The widespread use of biotechnology should also improve the competitiveness of the US dairy industry, as will the regional shift in dairying to larger farms in the South and West. This process will also be influenced by pollution control regulations which will accelerate the movement towards larger farms with bigger herds that can better meet the costs of compliance.

Despite the increasing competitiveness of the US dairy industry, and the widely held view that the US dairy industry should embrace policies that will allow it to take advantage of that competitiveness, dairy policy was subject to the most heated battles and directional shifts of any commodity during the 1995-1996 Farm Bill debate. Dairy reform proposals lurched from a complete free market, to a more controlled market, to a continuation of the status quo. At one point in the debate, dairy proposals became so contentious that they were stripped from the Farm Bill legislation altogether. This debate was driven mainly by sizable regional differences in product mixes and competitiveness between the New England states, the upper Midwest, the South and the West.

In general, producers in the New England states wanted leeway in setting their own prices, an agreement known as the Northeast Dairy Compact. The producers in the Northeastern and Southeastern states wanted to maintain the status quo. Upper Midwest producers wanted to scrap regional marketing orders which they believe favor other regions of the country. Southwestern and Northwestern producers wanted price supports to be phased down, so they could expand their exports of milk powder into the Asian market. California dairy farmers wanted to impose their milk composition requirements on the rest of the country. Also under consideration was a self-help program that, if enacted, would have a significant impact on the market.

Processors were more unified in their views. They wanted to phase down federal purchases of dairy products and price supports. They tended to oppose milk marketing orders and increased fluid milk standards. Some processors feared that increases in export subsidies could short the market. Adding to the mix were free-market conservatives and consumer groups who opposed dairy price supports.

What finally emerged is a four-year phase-out of dairy price supports. The dairy legislation sets milk support prices at \$10.15 per hundredweight, with annual reductions of 15 cents per hundredweight through 2000. After 2000, dairy support prices are eliminated. Also after 2000, farmers have access to recourse loans for cheese, butter and nonfat dairy milk at \$9.90 per hundredweight, milk equivalent, which must be repaid. Producer assessments are eliminated. Until 2000, the Secretary of Agriculture will have the authority to allocate purchases of dairy products between butter, cheese and nonfat dry milk to minimize the cost to the Treasury. Milk marketing orders (which establish regional pricing) are to be consolidated from 38 regions down to 10 or 14. The legislation also extends the Dairy Export Incentive Program to 2002, and requires the use of the program to the maximum extent allowed under the Uruguay Round Agreement.

These provisions represent significant reform of the US dairy industry, and impose market disciplines on the industry much sooner than many observers believed possible at the outset of the Farm Bill debate. They should move the dairy industry towards a more competitive international position over the course of the legislation. Even though the US exports only 2 percent of its production, the ongoing funding of the Dairy Export Incentive Program will continue to act as a depressant on world prices, but its impact should lessen as US prices move into alignment with world prices. The industry is also directed to establish an export trading company to conduct international market development.

Increased US exports will primarily come at the expense of the EU in the Middle East and South America. Because of the competitiveness of Australia and New Zealand, the US will find it difficult to expand its market share into Asia.

European Union

Over the longer term, the EU's dairy policy will come under a great deal of pressure for reform. The policy dilemma is this: In the absence of production quotas, dairy production would continue to increase. The increase would be in the staple products covered by intervention (butter, skimmed milk powder), which are the same products that are exported. Any effort to decrease the size of the production quotas could stimulate production by encouraging farmers to adopt cost-saving, output-enhancing technologies, and could lead to increased intervention purchases or exports. And, finally, abolishing quotas would destroy the equity position of thousands of dairy farmers.

In the face of this dilemma, the EU must decide if it wants to continue or even expand its significant export position on the world market—in particular, to the growing markets in Southeast Asia and South America—or produce almost exclusively for the internal market. This market is due to expand when the countries in Central and Eastern Europe join the EU in the first decade of the next century.

Before addressing this question, two important developments for the future of EU agricultural policy must be considered. The first is the probable extension of the EU to Central and Eastern Europe. It seems likely that the EU—inspired by political and strategic considerations—will accept the membership of most of the countries in Central and Eastern Europe, with the exception of the countries of the former Soviet Union. By the year 2005, the EU could comprise of 475 million consumers in 25 countries (compare with the present 370 million consumers in 15 countries).

The second important development is the expected continuation of the reduction in trade-distorting support in the agricultural sector in the next round of trade negotiations. It is clear that most of the trading partners in the developed and developing world will not allow the agricultural sector to be exempted from future negotiations.

These developments will force the EU to reconsider its existing agricultural policy, in particular its policies for dairy, sugar and meat. For cereals and oilseeds, the EU's Common Agricultural Policy will move internal prices gradually toward world market

prices. This policy dovetails with the expected further liberalization of international trade, as well as the EU's desire to remain an important cereal and oilseed exporter in a growing international market. It is also motivated by the fact that the Central and Eastern European countries are competitive producers of cereals and oilseeds.

The EU has decided that its existing dairy regime will continue unchanged until at least the year 2000, but the discussion has begun over the future direction of this regime. In a recent paper, EU Agriculture Commissioner Franz Fischler discussed three possible scenarios for the future of the Common Agricultural Policy (CAP). Under the first scenario, with no change in the CAP, dairy production in the (future) EU member states in Central and Eastern Europe will increase sharply while tariffs continue to decline, forcing the EU to implement more stringent production quotas. This outcome is very unlikely.

In the second scenario, the ECU's price support and quota system will be replaced by direct income support for dairy farmers who, in exchange, protect nature and the environment. In a recent speech, Fischler predicted that this approach could cost up to 15 billion ECU. This option would create significant budget problems and would be socially unacceptable.

The third scenario uses the evolving situation in the cereals sector as a model for other products, including dairy, with the aim of stimulating competition. This means gradually lowering prices and increasing production quotas for dairy products. It also implies providing compensation through income supports which are linked to production limits, in order to stay within budgetary caps.

The more export oriented EU member states—such as Denmark, the Netherlands and France (more for cereals than for dairy)—want to maintain the EU's important position on the world market. Germany and most of the Southern member states place a higher priority on preserving and extending the internal EU market for their products.

If the EU decides to maintain or even expand its export position, it will need to develop a dairy policy that keeps it competitive, at least with the US.¹ Many in Europe would like to apply the principles of the sugar regime to the dairy sector in order to have exports subsidized by producers.

Alternatively, the EU's dairy policy would need to become more market-oriented, implying further restructuring and rationalization, allowing lower prices to become possible. If this policy is adopted, the regulation of production will no longer be a necessary element of EU policy in the long-term.

If the EU decides not to maintain its export position, it will face a cut in its level of production due to increasing imports, shrinking exports, and the potentially significant productive capacity of the new member states. A price reduction will also take place, as a result of tariff reduction—how much of a price reduction depends on the result of the next round of WTO negotiations.

Japan

In Japan, the objectives of the present dairy support system are to increase production in an effort to achieve the highest possible degree of self-sufficiency, improve productivity by expanding the size of the herds, and streamline the production, processing and handling of dairy products.

Under current Japanese policy, the government, through the Livestock Industry Promotion Corporation, essentially manages stocks to maintain a stable price and to regulate supply and demand. The difference between the resulting market price and the guaranteed price is paid to the farmers in the form of a deficiency payment. By law, seven products are under control of the Livestock Promotion Council. Imports for specific markets (e.g., school lunch, livestock feed) are not controlled by the Council, but are restricted by import quotas.

The Uruguay Round Agreement will require a 20 percent reduction in the level of domestic support from 5 trillion yen to 4 trillion yen. With a minimum reduction in tariffs of 15 percent and the continuation of the existing level of access (already more than the agreed 8 percent of internal consumption), Japan can continue the existing system of production regulation and managed trade for the next six years. While imports of major dairy products will not increase as a result of the Uruguay Round Agreement, imports of other dairy products will rise from 124,640 tons to 133,940 tons.

There is a movement in Japan for a new direction in agricultural policies. Announced in 1992, the “New Policies” are an effort to cope with demographic and social changes in Japan. For dairy, the primary goals are to improve working conditions, improve competition through policy and regulatory reform, minimize the gap between internal and external prices, and mitigate the impact of dairy farming on the environment. In addition, the process of agricultural reforms is likely to continue in Japan as a result of the process begun by the Uruguay Round.

Although the practice of granting some form of direct aid to farmers as compensation for lower domestic prices and lower border protection might be feasible in some countries, it would be difficult to achieve a consensus on such an approach in Japan.

A more feasible approach would be a gradual and orderly reduction of the indicative prices for the major dairy products. A part of the reduction in price could be achieved through the aforementioned reforms that would rationalize dairy processing and distribution. The guaranteed price of raw milk for manufacturing would also be reduced, but not without additional cost reductions from streamlining dairy operations. It is unlikely that such drastic reforms could be fully implemented by the start of the next round of trade negotiations.

Australia and New Zealand

Australia has no barriers to dairy imports, provides no domestic subsidies to its producers, and offers only a small producer funded export subsidy. That subsidy is subject to reductions under the Uruguay Round Agreement. Because the Uruguay Round will have relatively little impact on market access in key importing countries, as a large exporter Australia does not stand to benefit significantly from the agreement. The most significant, positive impact of the Uruguay Round for Australia will be to reduce export subsidies that have depressed world dairy prices.

Like Australia, New Zealand does not have subsidies or protection for its dairy industry. Thus, Australia and New Zealand should have no difficulties in realizing their respective Uruguay Round commitments. A future global dairy regime based on genuine international competition suits these two highly competitive producers very well, in particular when world market prices are no longer negatively impacted by export subsidies.

Both countries can fairly easily bring more dairy cows into production should market prices warrant. The cost of converting a sheep operation into a dairying operation is roughly \$400,000. The more significant bottleneck in both countries will be the high cost of investment in dairy processing and marketing. Australia does have potential to become a significant exporter, particularly if the prices of alternative crops—wool and beef—remain low.

Other Potential Exporters

Countries in South America, such as Argentina and Uruguay, also stand to benefit from the agreement, because they are able to compete in the international market. The dairy sector is presently underdeveloped in these countries. Therefore, they are not expected to play an important role in the medium-term. However, with appropriate domestic policies and investment, over the long-term they could become strong competitors on the international market.

The Future Evolution of Dairy Policy

As this review indicates, the countries of the EU, as well as Canada and Japan, politically are not planning to change the effective level of support for the dairy sector in the short-term. They are aware that they will be forced to do so at a later date when a further reduction in tariffs and subsidies takes place. Only the US has changed its existing policy in the short-term, with the aim of joining Australia and New Zealand as a strong competitor on the international market.

As previously mentioned, it is highly probable that the reduction in tariffs and trade-distorting subsidies will be an ongoing process. If so, current dairy policy in the OECD countries (with the exception of Australia and New Zealand) must be reformed. If the reduction in support after 2001 continues in the same magnitude as expected during 1995-2001, guaranteed prices will come down considerably, independent of national decisions to continue controlling production through quotas.

It is therefore of great importance to begin the discussion now on what direction future dairy policy should take. Assuming that a continuing process of tariff and subsidy reductions will eventually lead to internal prices that more closely resemble world market prices, the direction of future policy will depend very much on the conditions under which governments can accept more open competition with third countries, on the internal as well as the international market.

During the Uruguay Round negotiations, all countries, with the exception of the EU, opposed the continuation of export supports. Thus, it is highly probable that the next round of negotiations will totally eliminate export subsidies. Those countries which can compete on the world market and which want to expand or begin exporting dairy products will not accept an agreement that will allow the EU and the US to continue to provide export subsidies following the next round of trade negotiations. Total elimination of export subsidies is also important for the controls they indirectly impose on domestic policies that stimulate dairy production through high price supports.

The inability to subsidize surplus production onto world markets and the continuing tariff reductions will force countries to lower guaranteed prices and accept world market prices for exported dairy products. It is highly probable that this process will lead finally to a level of internal prices that will make the continuation of a quota system no longer in the interest of the dairy sector. This would be true, in particular, in countries or trade blocs that want to play an important role exporting on the world market.

This would leave countries with the option of providing direct income support, not related to product or production (i.e., the green box in the Uruguay Round) and/or direct income support under production limits, when it is related to land area and/or number of animals (i.e., the blue box). The question then arises whether direct income support to dairy farmers is necessary in the long run.

Before addressing this question, it is necessary to recognize the complex nature of the dairy market, which can roughly be divided into two parts. One part consists of products which are voluminous and/or perishable (e.g., fresh milk products), while the other consists of less voluminous and much less perishable products (e.g., butter, skimmed milk powder, condensed milk, and bulk cheese).

In an open market, the voluminous and/or perishable products can withstand competition from products from faraway regions more easily, which is why it is less necessary to support their production (local prices are not directly related to the international price for the fat and/or protein content). For the second group of products the (normally much lower) price is determined by the world market. (While this distinction is still true, technology is changing rapidly, and is improving manufacturers' ability to reconstitute dairy products such as yogurt, fresh cheeses, and milk.)

One could argue that in a world without government support, milk production would not completely disappear in less competitive countries or regions. The price difference between the two groups of dairy products would prevent that.

The internal price level for perishable and/or voluminous products is determined more by internal market forces than by the international market. If a country wants to prevent the overproduction of these products resulting in low prices, production could be regulated through quotas as long as these quotas did not lead to prices so high that imports become more competitive.

Thus, it seems that there are two legitimate reasons for providing long term, direct income support to dairy farmers:

- Where governments want to continue to support agriculture because of social reasons (e.g., preventing depopulation) or environmental reasons in less-favored areas (e.g., mountainous and/or climatically disfavored regions). This kind of support has an almost permanent character.
- Where agriculture is potentially competitive, but first needs to be restructured. In this case, government support is necessary only temporarily (even in developing countries).

On the basis of the foregoing analysis, the International Policy Council on Agriculture, Food and Trade believes it is necessary that dairy policy in all developed countries be based on the following elements by the year 2001:

- Increased market access through lower tariffs in general, and probably no tariffs at all for sophisticated (i.e., high value-added) dairy products, except in situations when a safeguard clause has been agreed.
- Higher minimum access levels;
- The elimination of export subsidies in the dairy sector;
- The elimination of product-related production subsidies, such as deficiency payments;
- The use of temporary direct income support if restructuring of the dairy sector is necessary to become more efficient;
- The reliance on permanent direct income supports only for social and/or environmental reasons, particularly in less favored areas;
- The elimination or prevention of existing monopolies at the distribution and retail levels; and
- The provision of technical assistance to developing countries to improve their infrastructure in the dairy sector, which will be necessary to enable them to produce, market, and distribute their products in the global marketplace.

Is there an alternative? Many countries which currently employ a dairy policy based on very high tariffs, export subsidies, and production quotas would like to continue this

policy, because it realizes high prices for farmers without significant government outlays. These countries can probably maintain such policies if, during future trade negotiations, the dairy sector is exempted from further tariffs and subsidy reductions, or if dairy is subject to less stringent commitments.

However, during the Uruguay Round negotiations it was clear that an exemption for dairy products was not acceptable. It is improbable that an exemption will be possible in future negotiations either. The more likely scenario would be a continuation of a variable reduction percentage (an average of 36 percent, but at least 15 percent). But this only postpones the policy change which must eventually take place.

The International Policy Council on Agriculture, Food and Trade therefore believes there is no alternative in a world of ongoing trade liberalization, even as it recognizes that some of its recommendations could pose difficulties for some governments. The IPC nevertheless advises governments and the dairy sectors in those countries which still maintain a highly protective sector to prepare themselves, along the lines suggested in this paper, for the inevitable changes coming over the next few years.

Annex 1. Milk Deliveries and Production

1985-94, in thousands of metric tons

Graphs available only through printed version

Contact the IPC @ (202)328-5056.

Annex 2. World and Regional Market Shares

World Market Share	1990	1994
EU-12	55.5%	48.5%
USA	1.4%	4.4%
Australia	10.4%	16.3%
New Zealand	20.2%	23.3%
EFTA	9.6%	6.0%
Other	2.8%	1.6%
TOTAL	100.0%	100.0%

Market Share in Asia	1990	1994	1,000 Tons Milk Equivalent	
			1990	1994
EU-12	4,084	4,399	47.3%	39.6%
USA	102	76	1.2%	0.7%
Australia	1,840	3,178	21.3%	28.6%
New Zealand	2,211	3,077	25.6%	27.7%
EFTA	339	301	3.9%	2.7%
Other	60	74	0.7%	0.7%
TOTAL	8,636	11,105	100.0%	100.0%

Market Share in Latin America	1990	1994	1,000 Tons Milk Equivalent	
			1990	1994
EU-12	2,322	2,396	56.6%	50.6%
USA	84	396	2.0%	8.4%
Australia	162	556	3.9%	11.7%
New Zealand	1,102	1,253	26.9%	26.5%
EFTA	20	56	0.5%	1.2%
Other	413	75	10.1%	1.6%
TOTAL	4,103	4,732	100.0%	100.0%

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The Mission of the International Policy Council on Agriculture, Food and Trade

The International Policy Council on Agriculture, Food and Trade (IPC) is dedicated to developing and advocating policies that support an efficient and open global food and agricultural system—one that promotes the production and distribution of food supplies adequate to meet the needs of the world’s growing population, while supporting sound environmental standards.



Founded in 1987, the IPC is an independent group of leaders in food and agriculture from 20 developed and developing countries, including formerly centrally planned countries. Members are chosen to ensure the Council’s credible and impartial approach, and include influential leaders with extensive experience in farming, agribusiness, government and academia. The IPC meets twice annually to develop policy recommendations to address the critical issues facing the world’s agricultural system. It then conveys its recommendations directly to policymakers through its personal contacts and through a variety of papers and studies. The IPC also convenes task forces and holds conferences and seminars.