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Special Distribution

International Dairy Arrangement

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PROTOCOL REGARDING MILK FAT

Problems in Markets of Former Soviet Union

Communication from New Zealand

The following communication, dated 15 June 1993, has been received from the New Zealand Permanent Mission.

Introduction

1. Serious problems exist in the international butter market as a result of political and economic upheaval in the Former Soviet Union (FSU). Opportunities for commercial sales of butter and butteroil into those markets have been reduced. Coupled with levels of supply that exceed demand in available international markets, there has been increasing pressure on prices for butter and butteroil at the margins of the IDA minimum, particularly for sales into the FSU.
2. Weakness in the FSU markets can be expected to continue as efforts are made to stabilize the political and economic conditions in the FSU and as new trading and financial structures are established. This will maintain pressure on international prices for butter and butteroil in the markets of the FSU but also more generally, maintaining and possibly increasing the present serious disequilibrium in the international butter market. It will also strain the disciplines of the IDA, particularly where these disciplines are imprecise or uneven in their application.
3. There is therefore an urgent need for the development of a short-term solution to overcome the immediate problems for export trade into the markets of the FSU. There is also a need to find more durable solutions for dealing with problems in the FSU in ways that maintain the integrity and effectiveness of the IDA. This paper examines the nature of current difficulties and possible solutions for consideration by participants in the International Dairy Arrangement.

Background

4. The FSU market has historically been very important for the international trade of butter and butteroil. It has accounted for over 50 per cent of total international trade. It has also been an outlet for surplus supplies of butter for which no other market has been available or able to absorb significant quantities.

5. At the same time, the FSU market has been weak in terms of prices achieved. In the course of the last ten years there have been few instances and for relatively short periods when sales have been made above the minima fixed under the Protocol Regarding Milk Fat (see Annex). There has been a succession of price derogation arrangements agreed under Article 7, beginning in 1984/1985. The last formal derogation arrangement was agreed in December 1990 covering supplies delivered in 1991 and in the first part of 1992. These derogations successfully isolated the trade to the FSU, thereby avoiding disruption of other commercial markets for milkfats. The derogations also assisted in managing the reduction of large butter stockpiles accumulated by some members in the 1980s.

6. The weakness of the FSU market has been exacerbated by the dissolution of the Soviet Union in 1991. This caused a massive dislocation of the trade and payment system with Russia and other Republics of the FSU. It has left a legacy of problems relating to trade conducted under former arrangements, mainly in terms of an accumulation of large amounts of unpaid debt; and it has produced major difficulties with current and future trade because of uncertainty about the size of import demand and great confusion as to who conducts trade and can make foreign currency remittances to pay for imports.

7. These developments resulted in increasing supply pressure in export markets because of the absence of alternative markets to offset the diminution of demand in the FSU.

Recent developments

8. Against this backdrop, there has been a decline in international prices for butter and butteroil since the last quarter of 1992. Earlier in the year, prices had been at a healthy margin above IDA minima prices. In the last quarter, prices fell too hard on the IDA minima. Factors behind this fall were:

(a) Continuing uncertainty and difficulty in FSU markets

9. There was growing uncertainty about the extent of commercial demand for butter and butteroil exports to Russia and the other Republics of the FSU as a result of the developments in the FSU referred to above. No commercial sales had been made of any significance for many months up to that time and there was continuing uncertainty as to whom one could trade with and what funding would be available to make payments.

(b) Supply pressures

10. The uncertainties of the FSU markets were of particular concern to southern hemisphere suppliers because of their reliance on these markets. In New Zealand's case, there was the additional factor of unpaid debt from sales in 1991/1992. In the last quarter of 1992 southern hemisphere suppliers began to face in an acute way, partly for seasonal reasons, pressure from an accumulation of stocks for which no market outlet seemed

available. This resulted in heavy downward pressure in the international market on price expectations.

11. These pressures were compounded by increasing supplies of butter and butteroil from other sources. Non-IDA participants have since October 1992 been seeking to dispose of surplus stocks. There has also been a continuation of aid deliveries and the intermingling of these with concessionary commercial supplies from some exporters, notably the United States.

(c) Application of IDA disciplines

Imprecise controls on pricing

12. Pressures in the market place have been complicated through the mechanisms of the IDA governing sales at/or above the minimum. IDA participants use different methods for control of dairy export pricing, with varying degrees of precision. This can result in unevenness in the application of the IDA disciplines to export traders.

13. An example of where this imprecision can arise is in relation to exchange rate variations which can affect the prices at which the product is sold. The difficulty that can arise is illustrated in the case of the EC, the world's largest exporter of dairy products, as a result of the denomination of IDA minimum prices in United States dollars, rather than ECU, particularly given the movements in the United States dollar since October 1992. While the European Community's export refund scheme is administered to comply with IDA minimum requirements, actual prices offered by traders may differ from the calculated prices prepared to set export refunds because of variations in exchange rates.

F.o.b. pricing

14. The existing IDA mechanism places some participants at a greater disadvantage in a situation where prices are at the minimum. The f.o.b. price discipline is a built-in handicap for exporters such as New Zealand and Australia when sales are made in northern hemisphere markets, particularly the FSU. Margins returned to producers are significantly reduced due to additional transport costs for traders at a greater distance from export markets. The disadvantage for trade into distant markets by any trader could be avoided by the redenomination of the minima on a c.i.f. basis.

Price relationships

15. A further area of difficulty stems from the current relationship between the prices for pilot products and the underlying market trends in these products. New Zealand concerns about this relationship have been well elucidated in previous papers to the IDA. To reflect changing values between fat, and solids-non-fat, New Zealand has sought an increase in the minima for milk powders. Agreement by IDA members to increase the minima for powders and/or reduce the minima for milk fats would be in accord with these changes and would reflect the relative values of these components.

16. Rebalancing of minima would also be in accord with recent changes in the support prices for milk in the United States and EC, which have reflected the underlying shift in the ratio of milk component values. New Zealand would value an exchange of views between IDA members on the scope for further initiatives, both by way of internal support prices and changes in IDA minima, to better reflect market trends in the relevant value of fat and solids-non-fat products.

Need for solutions

17. The application of the IDA minimum prices for butter sales to the FSU, has, as the result of the conjunction of the above factors, placed increasing pressure on the IDA minimum. Though the problem is focused on the markets of the FSU, it also has wider dimensions which involve other markets and which extend to butteroil pricing.

18. This has not come about as a result of any particular design. It is a consequence of the way events have evolved in response to the unprecedented developments and dislocation of trade which are occurring as a result of the collapse of the FSU, and the increased supply pressure following the contracting in demand in that market. The resulting situation needs to be addressed if the integrity and effectiveness of the IDA is to be preserved.

Short term action needed

19. New Zealand proposes that IDA participants consider, as a matter of urgency, the introduction of a further derogation relating to butter sales to Russia and to other members of the FSU to allow such sales at prices below the IDA minimum. Such a derogation is needed to deal with the immediate difficulties in the markets of the FSU and the pressing need to enable sales to be completed this year in compliance with obligations under the IDA. The elements of a derogation would be a matter for agreement among IDA participants but our preliminary view is that it could permit any IDA participant to sell, without reference to the IDA minimum price, up to 50,000 tonnes of butter to the countries of the FSU, with contracts to be concluded before the end of this calendar year and deliveries to be made before the end of March 1994. A derogation along these lines would enable all IDA participants to pursue sales over the balance of this year in a manner consistent with the provisions of the IDA and pending further deliberations on the longer term solutions discussed below.

Longer-term solutions to be considered

20. New Zealand proposes also that IDA participants should consider as a matter of priority the identification of a longer-term and more durable solution to the continuing difficulties in the international butter and butteroil market. For this purpose, New Zealand sets out below a number of options that could contribute toward the achievement of such a solution:

- (a) Reinstrumentation of the minimum prices, expressing them in ECU or another European currency such as the Deutschmark (reflecting the major share that Europe has of the international trade in

butter and butteroil) rather than US dollars, to minimize the effect of currency exchange movements in particular when prices are near or at the IDA minima.

- (b) Definition of the minima for butter and butteroil on a c.i.f. basis to avoid disadvantaging traders distant from markets.
- (c) Approaches to significant exporters of butter and butteroil who are not currently members of the arrangement to encourage them to ensure that food aid transactions with the FSU have better regard to the legitimate interests of commercial exporters to those countries.
- (d) A downward adjustment in the level of the IDA minimum price for butter to take account of changes in the underlying value of milkfat and protein in major dairy markets.

21. Other participants may have other ideas to offer on other options that might also contribute to the achievement of a durable solution. These should also be considered by the Committee.

Conclusion

22. Recent difficulties in the international butter and butteroil market represent a major challenge to the IDA. One of the intended purposes of the IDA is to provide a forum for discussing and dealing with issues such as these in a way which ensures the orderly development of the international dairy market. To date the problem has not been given full consideration by the Committee of the Protocol Regarding Milk Fat. New Zealand has however been active in endeavouring to have the matters addressed in bilateral contacts with some participants. While these discussions have not resulted in definitive solutions, they have helped to elaborate the problems and enhance their understanding.

23. In bringing the matter before the Protocol Committee in this more formal way New Zealand hopes that IDA participants will recognize the seriousness of the situation in the international butter and butteroil markets and the importance of both short-term and long-term solutions being found if the IDA is to continue to be an effective instrument serving the interests of all its members.

ANNEX

BUTTER EXPORT PRICES : SOVIET UNION

