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Communication from Australia

The following paper, dated 10 November 1993, has been received from the Australian Permanent Mission with the request that it be circulated to all IDA members.

RESTORING EQUILIBRIUM TO THE WORLD BUTTERFAT MARKET

A Consideration of Options

Background

In recent years, individual members of the GATT International Dairy Arrangement (IDA) have expressed concern over the structural over-supply of the international butterfat market. Some factors contributing to this excess have been:

- the expanded availability of substitute products at prices considerably below those of butterfat;
- the continued insulation of domestic pricing structures from international market trends by major producers, and their reliance on subsidized disposal and stockholding programmes to help cover domestic production surpluses;
- increased food aid deliveries and concessionary export sales, particularly by non-participant countries; and
- the declining consumer preference for butter in developed Western economies.

Without doubt, however, the major structural change affecting the international butterfat market in recent years has been the substantial withdrawal of the countries of the Former Soviet Union (FSU) from the commercial market. These countries accounted for well over a third of world butterfat trade in the late 1980s. More recently, however, the proportion of world trade and the absolute volume of products shipped to the FSU has slumped significantly. This largely reflects the FSU's reduced capacity to purchase products, even on concessional terms.

The IDA Committee of the Protocol Regarding Milk Fat has recognized the serious nature of these developments, and the importance of finding an appropriate solution. As an interim measure, the Committee in June allowed individual participants to sell up to 50,000 tonnes of butter/butteroil to the FSU at prices below the prevailing minimum export prices, provided these sales were concluded by 31 December 1993, and the product was consumed exclusively within the FSU.

In approving this derogation, the Committee acknowledged the reservations held by several IDA participants, and agreed to consider alternative longer-term solutions to the current market imbalance. Its September meeting canvassed several options relating to the IDA minimum export prices. This paper examines those options in more detail to determine which, if any, of them provide the basis for an effective and appropriate response to the current international market imbalance.

Options for consideration

The options presented in September with respect to butterfat minimum prices fall into three categories - maintaining current prices, applying discrete cuts to these prices, and suspension of the minimum pricing obligations for some or all markets. The principal options presented in each category were:

Maintaining current prices

- retain the present minimum prices for pilot products;

- retain present minimum prices, but convert them from a US dollar per tonne basis to ECUs per tonne.

Discrete price cuts

- introduce a substantial one-off reduction in the minimum prices for butter and butteroil (or, at least, one of these products);

- reduce the butterfat minimums, but offset this by an increase in the minimum prices for milk powders;

- introduce a phased reduction in butter and butteroil minimum prices over time.

Suspension

- maintain the current minimums, but make provision for long-term sales under derogation to the FSU markets;

- suspend the minimum prices for butterfat for a period of twelve months; and

- permanently suspend the application of minimum prices on butterfat exports.

The merit of adopting individual options depends on whether they help meet the IDA's primary objective of promoting the expansion and greater liberalization of world dairy trade under market conditions which are as stable as possible, and which mutually benefit both exporting and importing countries. In practical terms this, in turn, depends on the nature of the international butterfat market, and the likely duration and extent of the current market imbalance. For example, if participants believe the current market imbalance is temporary, and that policies are in place which will resolve it early in 1994, they may favour maintaining the status quo. However, if participants believe the current market imbalance is more structural, they would have to favour options targeting the reduction or suspension of the current minimums.

To assist in this process, the next section outlines some of the key factors affecting the world butterfat market at present, and summarizes the likely short to medium-term outlook for this market.

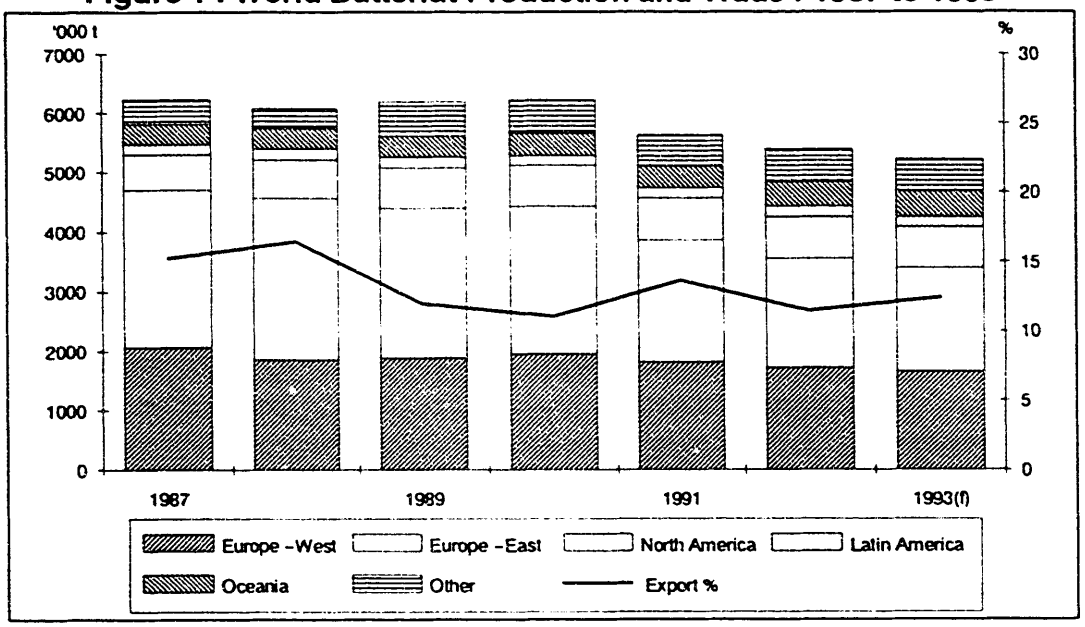
The international butterfat situation and outlook

Despite a decline in aggregate butterfat production since the late 1980s, the central characteristic of the international butterfat market in recent years has been the excess of the exportable surpluses of major producers relative to commercial import demand.

The FAO estimates world production of butter and AMF declined by one million tonnes between 1987 and 1993 (Figure 1). This decline has been concentrated in the countries of Eastern Europe and, to a lesser extent, the EC. These falls in European production have also been partly offset by an increase in available supplies from North America and Oceania.

In the case of Oceania, much of this increase has been concentrated in the past two years when favourable seasonal conditions encouraged an expansion in fresh milk supplies. Given local industry structures, the expanded milk supply has seen Australasian supplies of butter for export rise by over 30,000 tonnes since 1991.

Figure 1 : World Butterfat Production and Trade : 1987 to 1993



Source : FAO

The downward trend in aggregate butterfat supplies, however, has not given rise to an improvement in the underlying balance of the international dairy market. In fact, the decline in supplies has been more than matched by reductions in both the domestic and international demand for butterfat. As Figure 1 indicates, the proportion of world production sold in export markets (excluding intra-EC trade) has fallen slightly over the past five years, as international demand contracted.

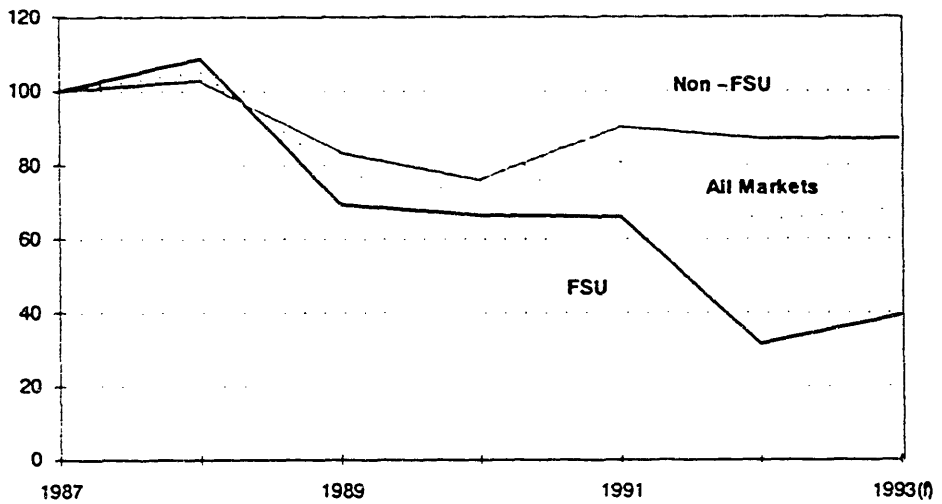
At the same time, per capita consumption in many developed economies has continued to decline putting pressure on internal supply balance in major producer countries. This issue is particularly relevant in the case of European butter supplies.

Annual Consumption of Butter (Kg. per capita) Selected Countries 1987 versus 1992			
	1987	1992	% change
W. Germany	8.1	6.8	-16
France	8.7	8.9	+2
UK	4.5	3.2	-29
Denmark	7.2	4.0	-45
Netherlands	4.0	3.3	-18
USA	2.1	1.9	-10
Canada	3.9	3.0	-23
Poland	8.0	4.7	-41
USSR/CIS	7.5	5.2	-31
Australia	3.1	2.6	-16
New Zealand	11.4	9.4	-17

While EC butter production has declined in recent years, available supplies remain well ahead of domestic commercial demand. In 1993, EC production of 1.6 million tonnes will exceed domestic commercial sales of locally produced butter by almost 600,000 tonnes. Consequently, subsidized disposals remain critical to the EC's internal market balance. The ramifications for the international market are more severe as the EC's exportable surplus in volume terms is close to the current level of international trade. These disposal pressures are compounded by the fall in per capita consumption of butter in recent years in EC Member States other than France. Therefore, even with its increased emphasis on subsidized disposals to domestic manufacturers, the EC must maintain annual exports of 220-250,000 tonnes to prevent rebuilding government stocks.

In the case of Eastern Europe, butter supplies have fallen significantly in recent years as they shift their production base from centrally planned to market-orientated systems. However, these production changes have been accompanied by market deregulation and the removal of local consumption subsidies. The resulting declines in butterfat consumption have more than matched the fall in local supplies, and led to a substantial reduction in the net demand for imports from this region.

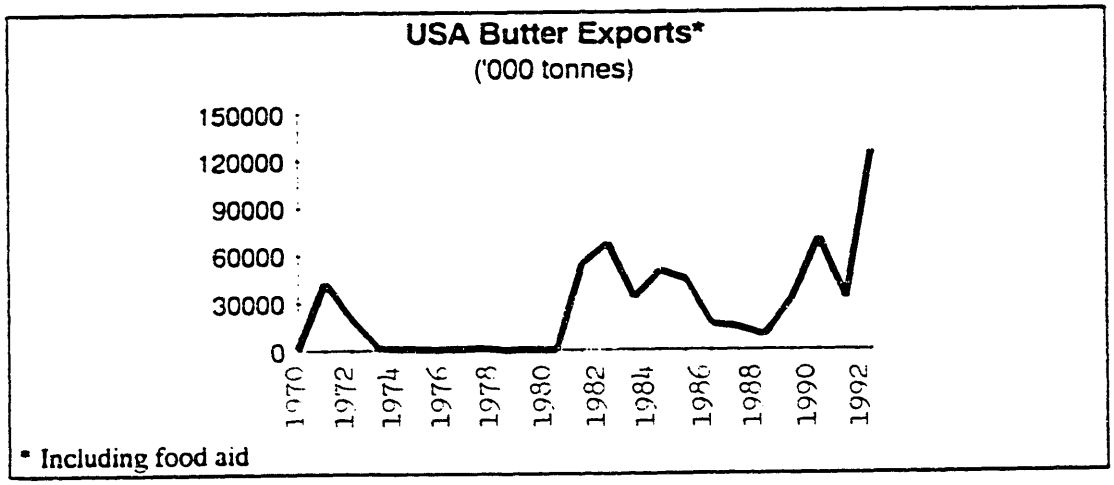
Figure 2: Butter Export Trade
(Index 1987 = 100)



The collapse in butter consumption in the FSU has had a particularly destabilizing effect on world butterfat markets. In the late 1980s, the major Western suppliers exported over 400,000 tonnes of butterfat to the FSU. This represented 40 per cent of all the product traded internationally. However, more recent exports to the FSU are substantially lower. In 1990 and 1991, they averaged around 250,000 tonnes, and dropped sharply in 1992 to 120,000 tonnes. While aggregate shipments in 1993 will recover slightly to around 150,000 tonnes, this mainly reflects an increase in United States food aid deliveries, rather than any improvement in commercial sales.

This decline in the FSU market has not been countered by increased uptake by other major markets. Domestic conditions have discouraged imports in important markets such as Algeria and Japan. In Japan, high domestic stocks have led to import tenders being curtailed, while Algeria's economic and political instability has reduced its capacity to commercially import butteroil. The economic recession in major Western economies has also added to international supply pressures by depressing consumption of butterfat products.

The above factors have seen the aggregate export trade in butterfat decline to around 620,000 tonnes in 1992 and 1993. The pressures generated by this decline in demand have been compounded by the rise in available supplies from Australasia and North America. While United States butterfat production has been relatively stable in recent years, there has been a substantial rise in the export orientation of its industry. United States butter exports (including food aid) more than doubled in 1992, and have remained at this higher level in 1993. This has placed considerable pressure on the commercial market opportunities available to other Western suppliers.



At this stage, there appears to be little real prospect of any substantial short-term recovery in commercial demand from markets such as the FSU, Japan and Algeria. Indeed the recent changes in Russian economic policies make it very unlikely that import demand from this market will return to the levels observed in the late 1980s for some time. This suggests that an improvement in overall market balance in 1994 and beyond will depend critically on policy adjustments in major supplier markets. However, neither the United States nor EC is expected to implement substantial domestic reforms in 1994.

With government stockpiles having stabilized, the EC is under considerable pressure to forego the cut in 1994 milk quotas announced as part of the 1992 CAP reform. If this results in a further

reduction in internal support prices in 1994, the impact of any such cut on EC export prices will depend on whether they are offset by matching changes in EC export refunds. However, without a reduction in quotas, the ECs potential exportable surplus of butterfat will remain in line with aggregate world trade. The level of export trade it needs to maintain internal market balance will also depend heavily on its maintaining domestic subsidized sales at their current high levels.

In the United States, the steady cuts in butter support prices in recent years appear to have encouraged some additional domestic commercial usage. Despite this, the surplus in United States butter supplies should continue over the next few years. Export volumes (including food aid) are also likely to remain well above "traditional" levels as the government seeks to minimize any build up in intervention stocks.

Further out, the conclusion of the Uruguay Round along the lines of current negotiating texts, offers the prospect of some relief to the market. The United States would have to reduce subsidized exports over time, although the real constraints imposed on EC butterfat exports are not as significant. Liberalization of import access should also create some additional demand, while the eventual stabilization of conditions in the FSU should work to improve market balance. However, factors such as the long-term decline in consumption of butter in industrialized economies will limit the gains on offer from the proposed agreement.

Restoring market equilibrium

The above analysis suggests that the international butterfat market will remain under considerable pressure throughout 1994, with available export surpluses well in excess of commercial demand. The current derogation sale to the FSU may help to improve this situation, but is unlikely to generate sufficient sales to restore an effective market balance. In the longer term, the FSU's decline as a commercial market will mean that available supplies will be more than sufficient to meet aggregate demand.

Maintaining current minimums

This finding calls into question the benefit of the IDA seeking to enforce the current minimum prices for butterfat next year. The severity of the current market imbalance makes it unreasonable to expect that the minimum price provisions will be effective in holding prices at the currently prescribed levels. Commercial pressures, including supply competition from non-participants such as the United States of America, the Baltic States and others, are simply too great.

IDA participants, therefore, will face increasing difficulty complying with the current minimum prices, particularly those countries that do not operate government minimum price and stockpiling arrangements. In these circumstances, seeking to enforce adherence to the current minimum price settings will not encourage a more stable market environment. Instead, it will place considerable stress on the framework of the IDA itself.

Re-denomination of the current minimum prices from US dollars to ECU also does not address the fundamental causes of the current market imbalance. Essentially this option aims to assist EC compliance with the minimum pricing provisions when world prices are close to the prevailing minimums. However, during 1993, world butterfat prices have remained under pressure even in those periods when exchange rate movements pushed up EC export prices. This demonstrates the rôle of both the EC and non-EC exporters in setting butterfat prices in the current market environment. In short, the central problem facing butterfat markets at present is insufficient demand resulting from the decline in sales to the FSU and other major markets. This means that supply competition between

non-EC suppliers is sufficient in its own right to place international butterfat prices under substantial pressure. This pressure will remain in 1994.

Discrete price reductions

This raises the issue of whether a reduction or suspension of minimum prices will help restore international market balance in the short to medium term. Reduced minimum prices do offer the prospect of helping improve commercial demand. In addition, by effectively increasing the cost of subsidized exports relative to domestic disposals, lower minimum prices may help to inhibit some of the current supply competition that is putting the international market under extreme pressure. However, the characteristics of the current trade in butterfat will make it very difficult to determine with any accuracy the level of cut that will be effective in achieving these aims.

Exports of butterfat constitute a very small part of the overall international trade in fats and oils. The butterfat trade can be further broken down into its two distinct sub-categories of butter and butteroil/AMF. The principal butter markets include the FSU and developed economies such as the EC and Japan. By contrast, the major users of butteroil are the recombining industries of Asia, North Africa and Central America. A smaller proportion of butteroil is used in these regions as an input to the food processing sector, and in consumer pack forms such as ghee.

Butterfat Price Relativities
1993

	US$/tonne
AMF IDA Minimum	1,625
Coconut Oil	446
Soya Bean Oil	437
Palm Oil	400
Sunflower Oil	450
Peanut Oil	622
Canola Oil	220

Source: FAO.

As indicated, butteroil trades at a substantial premium to substitute fats and oils. This effectively restricts its use to niche product markets, where taste and functionality considerations offset its price disadvantage. Most producers in South East Asia, for example, substitute vegetable oils for butteroil in their recombined products to improve its affordability among lower income consumers.

The large price gap between butteroil and competing fats/oils makes it very difficult to determine whether a specific cut in the current IDA minimum will be sufficient to generate increased demand. Certainly, a cut of one or two hundred dollars is unlikely to encourage any large-scale shift to butteroil by major end users in Asia (although the flow on from cheaper inputs into final product prices may help stimulate demand).

The characteristics of the major butter markets also make it difficult to assess the level of minimum price reduction that would be effective in stimulating demand. In the first instance, demand from markets such as the EC and Japan reflects domestic policy considerations (EC quota access for New Zealand and Japan stockpiles) rather than world market prices.

Given their economic circumstances, demand from markets such as Algeria and FSU is obviously more responsive to international price changes. However, factors such as the (in)stability in domestic policy and distribution structures are also important. In the case of Algeria, the availability of extended credit through United States GSM credits or European government insurance agencies will be as crucial to demand as nominated selling prices.

The uncertainty facing these major buyers, therefore, makes it almost impossible to establish with any certainty a new, lower minimum export price which will ensure an effective response in international butterfat supply/demand.

In fact, setting a new minimum price may act to exacerbate the current market uncertainty. Of itself, the new floor price for exports will not seriously reduce supply competition between producers and prices should fall to the lower level very quickly. However, the continuing supply pressures at the lower minimum price may encourage buyers to withhold purchases in the expectation of further reductions. (This is very likely to be the case if importers expect a phased series of reductions will be put into place.)

Suspension

The current uncertainty over pricing and policy trends suggests that the option most likely to help restore some balance to the international market is the suspension of the existing minimum prices.

The suspension of minimum prices will not immediately remove the current uncertainty facing world butterfat markets, as buyers and sellers will need some time to negotiate the sales and prices necessary to restore market equilibrium. However, the time taken to re-establish this equilibrium should be significantly shorter under a suspension approach. This is because a suspension option will allow the market to commercially generate a new equilibrium position. Therefore, there will not be the same incentive for buyers to hold off purchases in the hope of seeing further price falls (as may happen under a minimum price reduction scenario).

The suspension approach will also remove a major point of contention between IDA participants, namely their compliance with the IDA minimum pricing protocols in recent years. The issue to be addressed here is the form of suspension which best serves this purpose.

One option considered has been quarantining any suspension to the FSU market (either through rolling or permanent derogations). This has been the route taken by the IDA on previous occasions of severe market imbalance. Against this:

- establishing a permanent two-tier pricing structure in world markets would be strongly resisted by butterfat importers. It is also difficult to reconcile this step with the IDA's goal of mutual benefits for exporters and importers;

- the current derogation has shown there is no guarantee that reduced prices will significantly increase the volume of product demanded by the FSU in 1994;

- over the longer term, the FSU's capacity to soak up available butterfat surpluses is likely to be diminished; and

- economic pressures will encourage leakage of product from the FSU, particularly under a longer-term derogation.

These factors call into question the viability of seeking to quarantine lower export prices to the FSU (and/or other major markets such as Algeria) on a long-term basis.

The permanent suspension of minimums would enable international markets to operate on a more commercial basis. This will be important given the longer-term uncertainty over the level of international butterfat demand. In addition, this step would help address the United State's concerns with the IDA price minima. Therefore, it may help to encourage improved communication and

co-operation between major butter producers.

However, the majority of product entering the world market in coming years will continue to be substantially subsidized. One of the functions of the minimum price structure has been to restrain the use of disruptive "a-la-carte" export subsidies to increase sales in specific markets. As long as IDA members and non-members continue to subsidize dairy exports, the price minima can serve the purpose of imposing a discipline on them within a market where there is some balance in supply and demand.

This latter point favours the adoption of a temporary suspension of the minimum prices for both butter and butteroil on sales to all markets in 1994. This approach would enable commercial market forces to shift the international supply/demand balance closer to equilibrium over the coming year.

Of itself, this step will not guarantee that equilibrium is reached. However, of the options canvassed, this is likely to prove the fastest and most effective means of improving balance. It also will not unnecessarily distort trade flows to specific end-user markets. The temporary nature of this suspension also allows the IDA to make a further considered assessment of the international market outlook in 1994, when the details of the Uruguay Round negotiations (and their implications for farm policy in member countries) are better known.