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with Professor Bill Bailey

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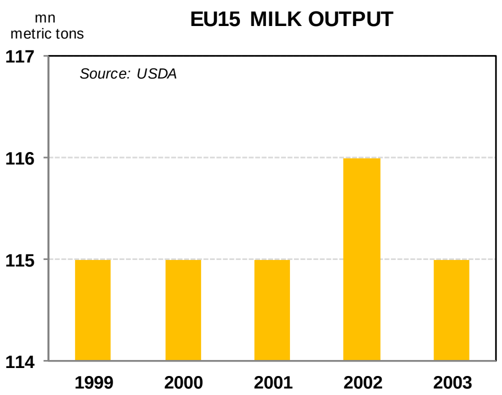
EU intervention stocks cast shadow over dairy prices

- After the removal of quotas, European dairy production has grown a modest 1%.
- However despite modest growth, European skim milk powder intervention stocks have grown to be (very) large.
- As a result, the large stocks are likely to hamstring global dairy prices over 2018.

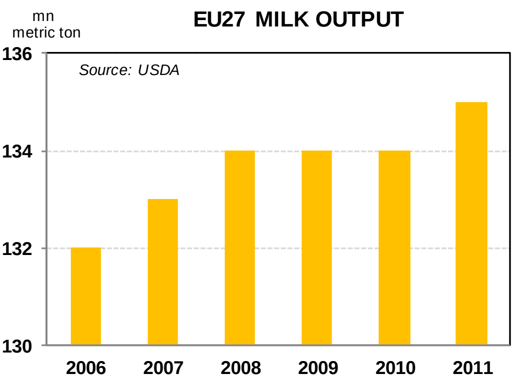
Fonterra cited EU intervention stocks, in part, for recent milk price forecast change

Fonterra recently reduced its forecast farmgate milk price for the 2017/18 season by 5% from its previous forecast. According to Fonterra, two key factors have led to the cut in its forecast numbers: strong European production and high European Union (EU) intervention stockpiles of skim milk powder (SMP). This report will analyze changes in EU production since production quotas were lifted in 2015 while providing some thoughts on 2018 production and reviewing the status and future of EU skim milk intervention inventory.



EU quotas have been consigned to history…

The removal of EU milk production quotas, effective March 2015, was not a surprise to the market. Quotas were first introduced in 1984. A variety of the EU's Common Agricultural Policy (CAP) program modifications slowly introduced market-orientation into farm programs. The end of quotas was first decided in 2003, and reconfirmed in 2008, well ahead of the final 2015 ending date, in order to help assure a smooth transition to non-quota production.



It is interesting that, between their introduction in 1999 and 2011, European Union production increases were limited to new countries entering the CAP rather than increased dairy output. For example, between 1999 and 2004 for the EU15, production was flat; for the EU25, between 2002 and 2005, production again was again flat; and, for the EU27, between 2006 and 2011, production grew by more than two percent.

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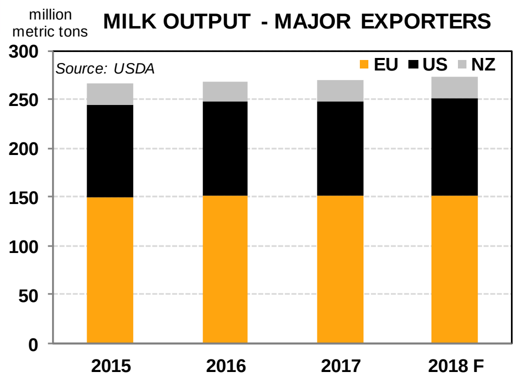


Clearly, production quotas were effective for a while, but beginning in 2006, new technologies and improving genetics became something that the industry tried and clearly adopted. However, between 2015 (when quotas ended) and forecasts for 2018, EU 28 production is expected to increase by only about 1%, despite a shrinking herd size. Clearly, there was a period of time the markets rewarded exceeding production quotas, but no more.

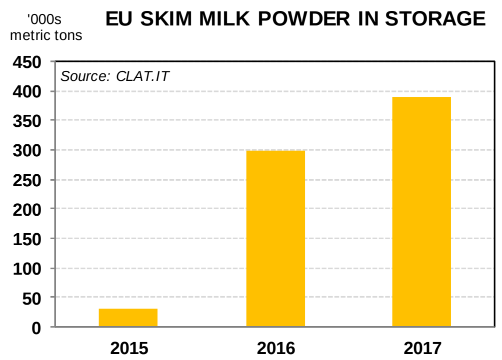
In contrast to the very modest 1.3% increase in EU non-quota output over 2015-2018, world production has increased more than 3%. During that period, US production is expected to be up 5% while New Zealand production will increase by about the same amount as European production – up 1.2%. Canadian production, reflecting a clear explanation for current US-Canadian dairy trade tensions, increased nearly 10%. The most significant increase in production, between 2015 and forecast 2018 is India, where the US Department of Agriculture (USDA) sees production increasing nearly 20%.

The limited increase in European production for 2018, up less than 1% from 2017, will be based on a blend of weak dairy commodity prices, largely a consequence of the significant SMP intervention inventory, and improved herd genetics. While the 2018 European dairy herd size is expected to remain basically unchanged from 2017, the increase in production will be a consequence of increased per-cow output. It is important to note the significance is that increase, while small, is technologically driven rather than a consequence of increasing herd size. This indicates the changes will be a permanent part of the European production process. Herd size may change but technology change remains a positive for production growth.

… but EU dairy market distortions remain

Despite very limited increases in EU milk production, the continued negative outlook for dairy prices is driven, in large part, by the significant shadow of SMP intervention stocks looming over the market. The challenge, and it is a considerable one, facing the European Commission (EC) is how to move those intervention stocks into the market while not having a negative impact on price.

Indeed, EU intervention stocks continue to cast a shadow over global dairy prices



As of October 2017, there were nearly 400,000 tonnes of SMP in intervention storage, waiting to be offered for tender. While there was a slight decrease in stocks during 2017 from previous inventory levels, the amount of inventory waiting to be sold back into the market continues to have a negative impact on dairy prices. And the difficulty EC has experienced during their efforts last year to sell their SMP inventory is a clear indication of a continued bearish market outlook. Buyers are asking, "Why buy it now when the next tender will reveal an even lower price?" Further, a key policy tenet for the European Commission has been not to sell inventory at any cost, but to maintain market balance and encourage price recovery. The rejection of tender bids during 2017 was a clear indicator that the policy remains in place.

However, the existence of the stocks sends a message to the markets that these stocks will, sooner or later, be released into the market. They wonthat every dad when prices decline but eventually, when prices start to move up, the stocks will come into the market, effectively stopping a market rally. Consequently, as long as those stocks may come into the market, prices will remain depressed.

In 1981, the US government had sufficient dairy stocks in its inventory so that every dairy cow in the country could have fallen over dead and those inventories would have been sufficient to meet consumer demand for butter for 6 months, and for nonfat dry milk for 2 years. The USDA devised a variety of ways to move those inventories into the market, such as school lunches, prison feeding programs and direct consumer donations, and exporting the products, often through export subsidy programs. It was able to dramatically reduce dairy inventories with only limited market impact. The result was market prices, which were flat while the USDA inventories hung over the market, rebounded once those inventories disappeared. The EC could easily be more creative than it has been to reduce SMP inventory without further weakening prices. Those weakened prices, in turn, will harm New Zealand dairy producers. Currently the US dairy program requires USDA to purchase, for donation to low income groups, dairy products when dairy prices decline. Such a policy recognizes the link between low prices and inventories by requiring the USDA to keep its inventory low by mandating the USDA purchased products be donated to low income groups rather than stored.

Looking forward, there is no clear path that isn't price negative for the EC. The EC recently adopted a proposal giving it complete control over adding stocks to intervention in 2018. This will be done by removing a specific price at which SMP stocks would be purchased, beginning when intervention reopens March 2018. The change would put the initiative in the hands of the seller as they offer to put stocks in intervention through a tender system. Such a move, however, does not address the volume of SMP stocks currently hanging over the market. So, until EU milk production declines, reducing the need to purchase inventory to keep prices up, and inventories are reduced, prices are expected to remain depressed.

About the author

William C Bailey was Chair of Agribusiness at Massey University for 13 years. He has written weekly world dairy market columns for ASB Bank for almost 15 years. He currently is President of Topker Consulting, specializing in agricultural market research and supply chain issues relevant to agriculture. He retired as Dean, College of Business and Technology, at Western Illinois University, in Macomb, Illinois, in July, 2017. Bill spent 5 years in the US Marine Corps and received his PhD in Agricultural Economics from the University of Missouri. Before shifting to New Zealand, Bill was Chief Economist for the US Senate Committee on Agriculture, Nutrition and Forestry, served as Deputy Undersecretary of Agriculture and was Vice President and Director of Research for World Perspectives in Washington, DC. His beer of choice is Tui. Contact Bill: topkerconsulting@gmail.com Phone: +1 309 333 5117

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