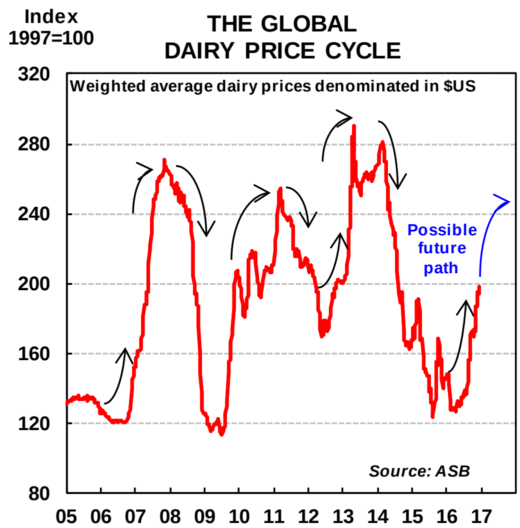
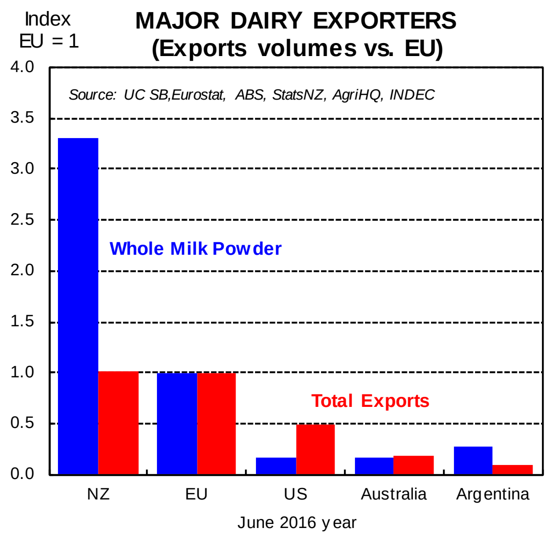
Lessons from the dairy downturn – Part I

- Global dairy cycles come and go, come and go…
- NZ has an over-sized effect on the global dairy cycle.
- Meanwhile, farmers in all parts of the world respond and change behaviour when they are losing money.

Summary

In this report, we reflect on the recent dairy downturn. For starters, our aim is to pull out some key lessons based on our observations during this latest dairy cycle. Later in the year, we would like to point out ways that the sector may adapt to or even influence the global dairy cycle. We suspect, for example, that NZ farmers aren't entirely hostage to the whims of global dairy markets. But that's for later, for now; here are the three key lessons we have learnt.





Lesson 1: global dairy cycles come and go…

Looking back at this downturn, one of the reasons the ASB Economics team was confident that the milk price would lift was our belief in the global dairy cycle. Indeed, our belief was that the cycle was alive and kicking, and that it was a matter of when, and not if, it would kick in. So why were we so confident?

Firstly, commodity cycles have been around for millennia. And hence, will be around for millennia to come. On that basis, we thought that for the dairy cycle not to kick in, something would have had to have changed drastically.

In that regard, some commentators pointed to lifting EU quotas as drastically changing the dairy export game. But for us, lifting quotas did not materially change the EU's competitive position – the EU remained by and large a high-cost producer.

As a result, we expected that the low milk prices would eventually impact on the EU in the same way low milk prices were impacting here in NZ. In other words, the dairy cycle was going to kick in, and that has been borne out over 2016 (see also lesson 3).

Lesson 2: NZ has an over-sized effect on the global dairy cycle

NZ is a large dairy exporter. Actually it's the largest. Over the June 2016 year, NZ exported 2% more dairy products (measured in metric tons) than the second-largest exporter, the EU.

When it comes to whole milk powder (WMP), our largest export, NZ dwarfs all other exporters. Over the same June year, NZ exported more than three times the level of EU WMP exports. In fact, NZ exported more than double the amount exported by the four other major exporters combined.

Given NZ's large share of global dairy exports, it should come as no surprise then that NZ has a large impact on the global dairy cycle. Put differently, that means changes in NZ supply have a large effect on global dairy prices.

Recent experience bears out this fact. NZ supply and exports surged following the record-high milk price in 2013/14. And as a consequence of the surge in production, global dairy prices sunk to very low levels. NZ farmers have then responded to the low global prices by reining in production; in turn, this response has led to a rebound in global prices, particularly for WMP, over the second half of 2016.

The other lesson we take from these points is that contrary to general belief, NZ farmers are not necessarily subject to the

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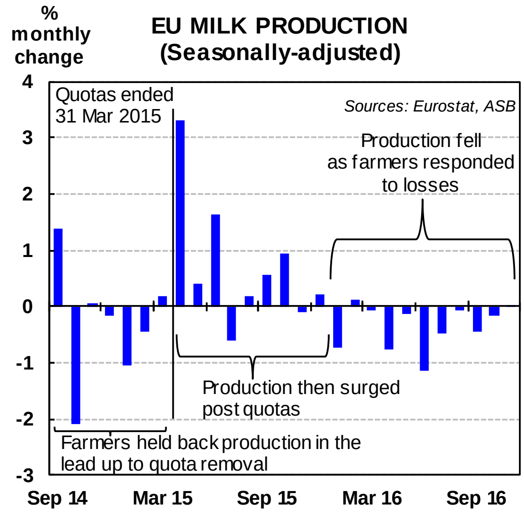
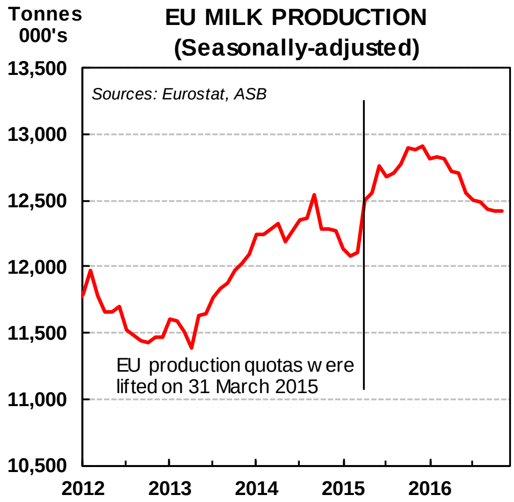
whims of global dairy markets. Indeed, NZ farmers have more pricing power than they are normally led to believe. In short,if NZ farmers produce the less, they will get paid more, with the net effect higher incomes overall.

With this in mind, we will explore later in the year what this lesson means for NZ dairy in Part II of *Lessons from the dairy downturn.* That is we believe that the sector can do more to deliver higher prices to farmers, and also less volatile prices to boot. Watch this space!

Lesson 3: When farmers lose money, they change behaviour
This last lesson almost seems too silly to point out. But point it out we must. Early in the year, we argued that the level of global dairy production was unsustainable given that the majority of exporters were losing money.



However, some commentators insisted that production could continue at these levels, via a combination of government support, including intervention schemes and other mechanisms. Our view was the best that these measures could hope for was to delay farmers' response.



Generally, when farmers lose money they change things. For a start, they may reduce herd numbers i.e. send some animals to slaughter to generate some cashflow. Farmers may also reduce expenditure on items such as feed, fertiliser, maintenance and animal health. For example here in NZ, it is generally accepted that over this latest downturn, farmers have relied more on pasture for feed than in preceding seasons.

Moreover, these changes generally led to less supply. And in turn, this supply fall generates a lift in prices. In other words, falling supply kicks off an upswing in the dairy price cycle.

Last year, the EU has illustrated this simple concept well. Back in March 2015, production quotas were lifted and this generated a surge in production. But what we observed was that it soon became apparent to European farmers that this new higher level of production was unsustainable. Farmers were losing money and they needed to change behaviour. And so they did – from the start of 2016, EU production began to fall in seasonally-adjusted terms (and has fallen ever since, see charts above).

In that sense, EU farmers are no different to their NZ counterparts.

Summary
As we come out of one cycle, we can already see the next taking shape. With the above in mind, we can anticipate that the same lessons from this cycle or general rules will apply again in the next cycle.

At the same time, we suspect, contrary to the widely held belief, that NZ farmers aren't entirely hostage to the whims of the global dairy cycle. Indeed, we would like to point out ways that the sector may adapt to or even influence the cycle. For that discussion, we'll be back later in the year.

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