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A Perfect Storm for EU Dairy Prices

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Dairy and Products

Agricultural Situation

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Report Highlights:

Milk production margins in the European Union (EU) have turned negative in recent months as EU farmers continued to increase production following the end of the EU dairy quota system on April 1, 2015, while ignoring decreasing world dairy demand. The extension of the 2014 Russian embargo on agricultural imports has added additional downward pressure on dairy markets. This has led farmers in France to start protests, blocking roads, but also retail distribution centers and supermarkets. Belgian and U.K. farmers soon joined these protests that will culminate in Brussels during the September 7 special Agricultural Council meeting. Long-term outlook for global dairy demand remains promising, even if the current sluggish dairy market situation may not disappear overnight.

General Information:
Introduction
For several years, agro-economic models and forecasters have signaled a bright future for world dairy markets, with world dairy demand increasing as a result of expanding middle class populations in Asia and Africa turning to Western diets. However, milk production margins in the European Union (EU) have turned negative in recent months as EU farmers continued to increase production following the end of the EU dairy quota system, while ignoring decreasing world dairy demand. The extension of the 2014 Russian embargo on agricultural imports has added additional downward pressure on dairy markets. In late July, EU dairy farmers joined pig farmers in France and later in Belgium and the United Kingdom in protesting low farm gate prices. Protesters blocked roads and retail distribution centers, and even pulled milk products from retail shelves to donate to bystanders. Nevertheless, long-term outlook for global dairy demand remains promising, even if the current sluggish dairy market situation may not disappear overnight.

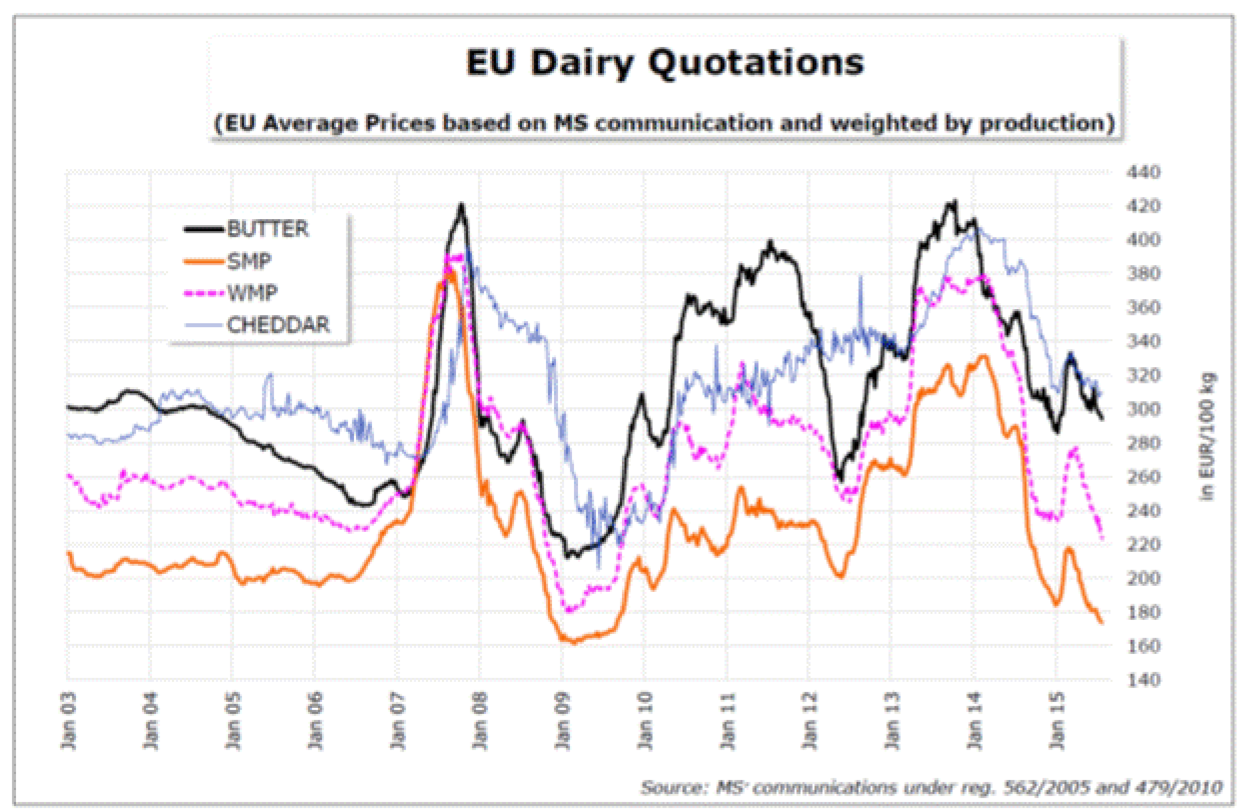
After the 2009 dairy price crisis, the European Union (EU) experienced a prolonged period of high prices for dairy commodities started, which was only briefly interrupted in 2012. During this time, the European Commission decided as part of the 2008 Common Agricultural Policy (CAP) Mid-Term Review to allow the EU dairy production quota system to expire in 2015. To prepare the dairy market for the end of the quotas, the Commission instituted a "soft-landing" program that would depreciate dairy production quota rights by gradually increasing the allowed quota level by one percent per year for five consecutive years from quota year 2009-2010 through 2013-2014. For the last production year before the quota system expiration (2014-2015), no further increase would be provided. This approach succeeded in increasing production gradually as anticipated, except in several of the core dairy-producing Member States (MS) in which dairy farmers greatly increased their production to benefit from good market demand and high dairy prices during the market recovery from the 2009 dairy crisis.

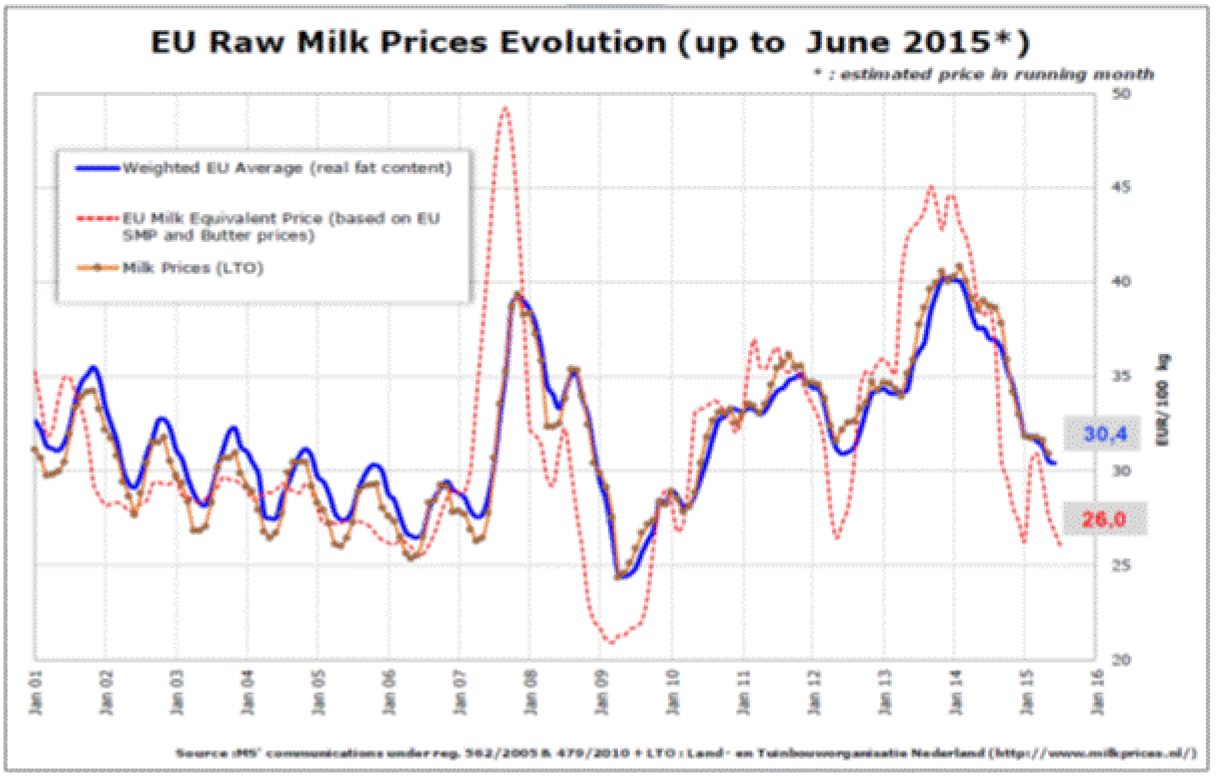
Even in high-producing MS, the "soft-landing" program still managed to decrease dairy quota values as the quota rights market became more fluid with high-producing farmers taking over production quota rights from underperforming farmers or farmers that quit dairying altogether. The quota rights market dynamics led farmers to speculate that they could out-produce their individual production rights by taking advantage of unused production quota from underperforming farmers who failed to sell their surplus quota rights. By 2013-2014, this speculation allowed dairy farmers in some MS to overshoot their individual production quota by up to 10 or even 20 percent at no cost. Dairy farmers would gladly pay the fines, or "superlevy," for overproducing and exceeding their quota rights because dairy prices were at record highs. Additionally, agricultural forecasters at this time, from the EU's own Medium-term Agricultural Outlook [1] to OECD and FAO reports, were projecting increased world demand for dairy in countries because of larger emerging middle class populations in China and other countries.

However, even though world prices started to level off in the spring of 2014, EU farm gate milk prices did not decrease until late 2014. As a result, EU dairy farmers kept increasing production in the interim despite the absence of a 2014-2015 production quota increase. Even the Russian import embargo on EU dairy products in August 2014 failed to decrease production, as dairy processors simply redirected their processing capacities away from cheese for the Russian market to butter and skimmed milk powder (SMP) for which new markets still seemed readily available. Finland and the Baltic MS (Estonia, Latvia, and Lithuania) were hit hardest by the Russian embargo because of their dairy exports were almost exclusively oriented towards the Russian market. Although the European Commission opened a Private Storage Agreement (PSA) scheme to help these MS, it was forced to close the scheme within weeks because other MS unaffected by the embargo took advantage of the scheme to make an additional profit.

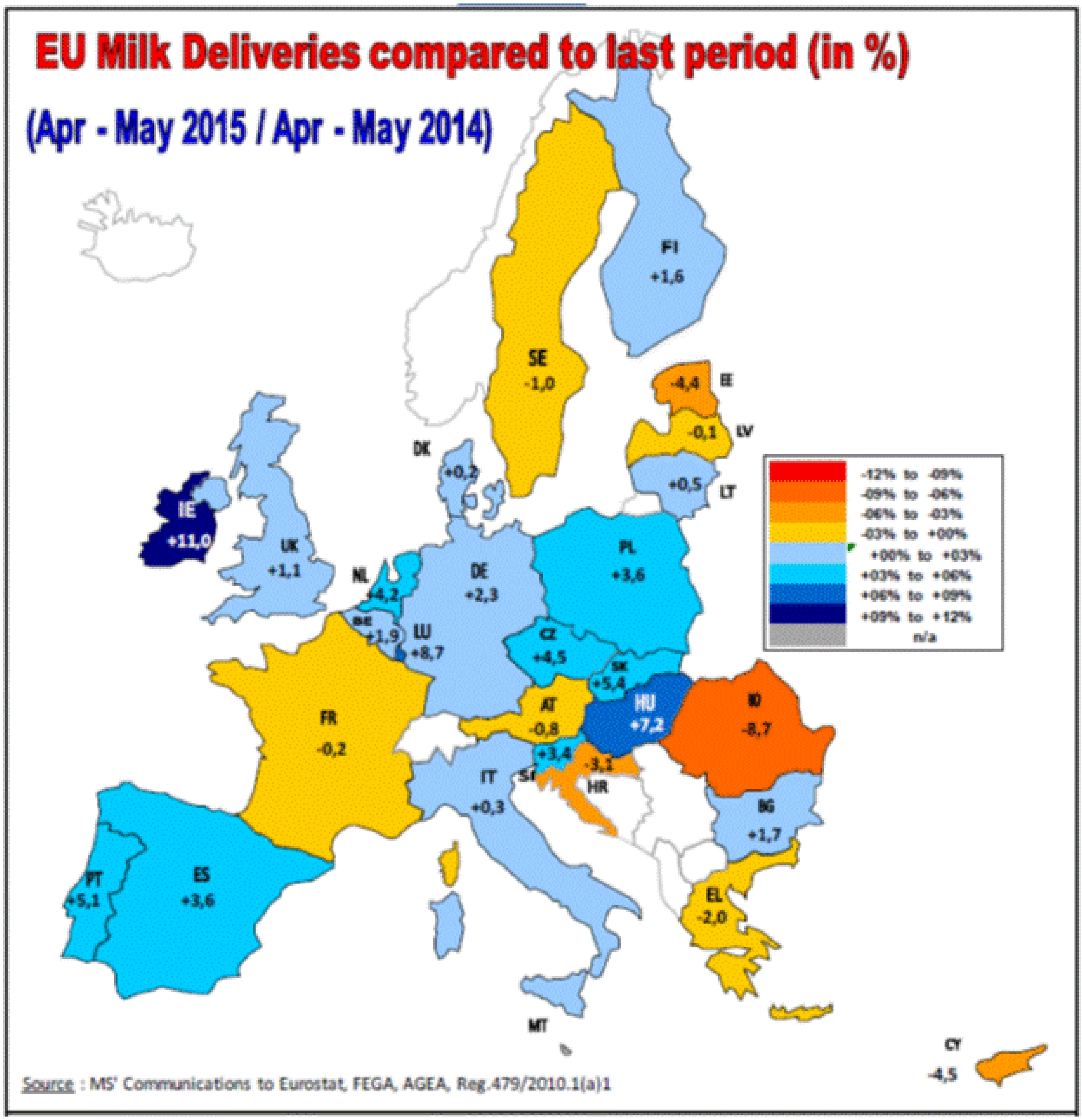
World markets continued to weaken, particularly as Chinese dairy imports decreased significantly in response to a slowing economy and large residual stocks of SMP. However, EU farmers failed to decrease milk production until the spring of 2015, far too late to avoid large “superlevy” fines for overshooting their last national production quota. As a result, 13 MS are expected to incur EU “superlevy” fines totaling up to €800 million in 2015, compared to €409 million from 8 MS in 2014.

[1] http://ec.europa.eu/agriculture/markets-and-prices/medium-term-outlook/2014/fullrep_en.pdf





Source: European Commission



Source: European Commission

Despite the worsening market conditions, farmers in many MS expanded milk production when the EU quota system ended on April 1, 2015. Increasing milk production in all major world dairy-producing countries further accelerated the drop in world dairy commodity prices. By late July, EU prices for SMP decreased to the lowest level since the 2009 crisis, triggering the first EU intervention storage sales, from Lithuania, followed by intervention sales from Belgium and Poland. Intervention stocks are owned by the European Commission for extended periods, as opposed to PSAs, which are for a predetermined short period and remain owned by the processor.

Also in July, French dairy farmers took to the streets to protest low farm gate dairy prices and the alleged “dumping” of products onto the French market from Germany and Spain. In an attempt to quell farmers’ protests, the French government approved €600 million in state aid on July 22 to support French animal production and asked dairy processors to maintain farm gate prices for milk at 34 eurocents/l on a voluntary basis. The measures failed to mute farm protests and farmer protests soon began in Belgium and Great Britain as well. The EU farmer’s association, joined by specific dairy farmer organizations like the European Milk Board, have already announced major protests in Brussels at the occasion of the special September 7 Agricultural Council organized by the incoming Luxembourg presidency.

The dairy outlook is not expected to improve rapidly as the last two auctions from Fonterra’s Global Dairy Trade (GDT) index [1] , the world’s most important futures market for dairy products, saw further price decreases of 10.7 and 9.3 percent. Emergency measures for expanding SMP and butter intervention schemes, agreed to in the latest CAP reform, were already announced by the European Commission and will be up for a vote by MS at the September Council meeting. These measures will bridge the gap from the end of the regular schemes for intervention and PSAs at the end of September until next year’s scheme opens on March 1. The emergency measures would reportedly also extend the volume of butter acceptable for intervention to 50,000 MT for calendar years 2015 and 2016 from the current 30,000 MT, while the volume for SMP intervention would be maintained at 109,000 MT. Although farmer organizations are demanding that the Commission increase the price levels for EU intervention and return 2015 dairy “superlevies” to the dairy sector, the Commission is unlikely to agree to these demands for budgetary reasons as well as political.

With GDT futures contract prices continuing to decrease on a weekly basis, the EU’s latest Short-term Outlook [2] forecasts that EU milk production for 2015 and 2016 will increase by only 1 percent on a yearly basis. However, with an upturn in EU economy expected in 2016, the Commission hopes that the current EU dairy crisis will end in the spring of 2016 when increasing EU domestic consumption is able to absorb most of the additional milk production.

Source: Global Dairy Trade

[1] https://www.globaldairytrade.info/en/product-results/

[2] http://ec.europa.eu/agriculture/markets-and-prices/short-term-outlook/pdf/2015-07_en.pdf