Free-Trade Agreements: Effect On The U.S. Dairy Industry

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International trade is one of the hot topics in dairy circles these days. Look at the record of key dairy issues at the national level last year. First it was humanitarian assistance to the former Soviet Union, under which over $100 million worth of U.S. dairy products were shipped to the former Soviet republics last winter. During the spring, U.S. dairy interests successfully opposed increased imports of Goya cheese under the Generalized System of Preferences (GSP) program and stopped domestic price undercutting by imported Swiss cheese. Summer saw the conclusion of negotiations for a North American Free Trade Agreement (NAFTA), which would progressively open up trade in dairy products between the U.S. and Mexico.

By last fall, commercial exports of U.S. dairy products under the Dairy Export Incentive Program (DEIP) began to reach levels that attracted widespread attention. Under the DEIP, contracts to commercially export about 2.65 billion pounds (milk equivalent) of U.S. dairy products were signed during 1992. By winter, an agreement on agriculture reached between the U.S. and the European Community (EC) seemed to pave the way to wrap up the 6-year-old Uruguay Round multilateral trade negotiations under the General Agreement on Tariffs and Trade (GATT). While the GATT negotiations are not moving as fast as was thought late last year, nevertheless an eventual GATT deal would bring further changes to the U.S. dairy industry, both in terms of additional imports as well as additional export opportunities.

Involving such things as DEIP, GATT, NAFTA, GSP, GSM, and the EC, this may all appear more like alphabet soup than serious matters U.S. dairy farmers should pay attention to. But international trade has come to the U.S. dairy industry to stay, and it will have an increasing impact on all our bottom lines.

In my comments, I want to focus on free trade agreements, such as NAFTA and the Uruguay Round negotiations under GATT. How will they fit into this overall picture of a greater international orientation for the U.S. dairy industry? How will they effect the industry?

Background

The United States possesses one of the world’s largest and most productive dairy industries. In comparison with the dairy industries of other countries, particularly industrially developed countries, the U.S. dairy industry ranks at or close to the top by such measures as total milk production and productivity per cow. In 1991, 148.5 billion pounds of cows’ milk was produced in the U.S., more than was produced in any other single country. The U.S. ranks second in total production behind the 12 countries of the European Community (EC), which maintains a common agricultural policy with respect to manufactured dairy products and international dairy trade. During 1991, 240.4 billion pounds of milk were produced in the EC. Furthermore, the U.S. would rank in third place in terms of milk production in the world overall if the 15 republics of the former Soviet Union, which collectively produced 223.2 billion pounds of milk in 1991, were counted together.
By various measures of efficiency of milk production, the U.S. also ranks at or close to the top. The average cow in the U.S. produced 14,868 pounds of milk during 1991, which was the second highest national average milk cow yield in the world. Only the small and highly intensive dairy industry in Japan showed a higher average per cow yield in 1991, at 16,843 pounds per cow. Furthermore, in terms of such measures as cost per unit of milk production, the U.S. ranks lower than all but a handful of countries with pasture-based dairy industries.

Given the size and efficiency of the dairy industry in the United States, it is particularly remarkable that our industry ranks very modestly in terms of the role that international trade plays in the industry overall at this point in time. In terms of exports, ours is an industry whose marketing focus, with a few exceptions, has been confined almost exclusively to the domestic commercial market.

For example, of all the major internationally-traded dairy products, cheese is by far the most important in the domestic dairy economy. Over half of the U.S. milk supply used for manufactured dairy products is used to make cheese, and almost a third of total U.S. milk production is used for this purpose. Yet the U.S. accounts for scarcely one percent of the world’s cheese exports. During 1991, the U.S. exported less cheese than the European Community, New Zealand, Australia, Switzerland, Austria, Finland, Norway, Bulgaria and Hungary, countries which are either much smaller producers than the U.S., or higher cost producers, or both. The U.S. ranks far below all developed countries, with the exception of Japan and South Africa, in the proportion of its domestic cheese production that it exports.

Though somewhat less dramatically, this pattern repeats itself for butter and most other dairy products. Only for whey, lactose, ice cream and, in certain years, milk powder have U.S. exports represented a significant proportion of either world trade or U.S. production volumes.

There are several reasons why the U.S. historically has not been a major player in international dairy markets. The domestic market has generally experienced sufficient growth to absorb most of the additional milk production generated by rising productivity. In addition, since most developed countries are at least self-sufficient in dairy production, demand for internationally traded dairy products has been largely confined to developing countries with limited financial resources to support their demand.

Most importantly, over the past two or three decades, Western and Northern European governments have aggressively supported their domestic dairy sectors through a combination of high price supports and large-scale export subsidization of the resulting surplus production of milk and dairy products. The United States, following a less aggressive policy of support and export subsidization, has faced entrenched competition and unattractive prices when it looked for dairy marketing opportunities beyond its borders. The U.S. export track record during this time consisted almost exclusively of low-price government sales of dairy commodities acquired in the course of domestic price support operations. International Dairy Trade Outlook for the U.S.

In the late 1980’s, this picture began to change. The European Community, by far the world’s largest subsidizing dairy exporter, imposed production controls on its dairy sector. While still operating at a substantial surplus, the EC dairy industry is expected, through a combination of budget pressures and policy reform, to be brought steadily, if slowly, into a position of greater supply-demand balance. This will come about through a combination of EC budgetary difficulties and internal political pressure to reform the Community’s agricultural support programs. This has, and will continue to, result in a gradual reduction of world stocks of dairy products, cutbacks in subsidized export volumes and slowly rising world prices.
The market situation facing the U.S. dairy industry is also changing on the demand side, both domestically and internationally. In the U.S., the market for food is mature, with an outlook for little overall demand growth. Population growth, a primary engine of growth in dairy product consumption, is expected to slow from the present 1.0% annual rate to half this level in the next decade. The population is ageing and becoming more ethnically diverse, which will likely cause domestic per capita consumption of dairy products to decline from recent levels. These population changes, combined with projections of slow growth in domestic food expenditures and with other factors, points to only modest growth, if any, in domestic consumption of dairy products. The domestic market, therefore, will be unable to absorb increased production stemming from an ever-rising level of productivity in the U.S. milk production sector in the future.

On the international side of the demand picture, the situation is evolving in quite a different direction. The economies of many countries in Latin America and Asia are undergoing rapid development, resulting in rapid growth in per capita incomes. This income growth and the spreading westernization of diets is fueling rapidly rising demand for high-quality food products, including dairy products.

An excellent illustration of the importance of the dietary changes sweeping the rest of the world, and their potential impact on our industry, can be found in a recent newspaper report on the growth patterns of the Japanese people. This article reported that, over the past 30 years, the height of the average Japanese male has increased nearly 4 inches, while average female height has gone up almost 3 inches. Interviewed as to the reason for this remarkable change, the director of nutrition for Japan’s health ministry responded, “the chief reason for the increase in body size is almost certainly diet. The dominant pattern of Japanese dietary change since World War II has been westernization. Grains, particularly rice, have declined in importance, and the caloric intake from animal foods has increased sharply. Meat and dairy consumption has gone way up.” This official concluded on a very interesting note by remarking that, “this is one of the mysteries of Japan. Once we decide to do something, all over the country, everybody does it.”

Japan is just one Asian country, which happens to be further along the path of economic development than others. Projected to the billions of people in all of Asia, Japan’s experience points to a very large potential rate of growth in international demand for dairy products. Furthermore, none of these countries is self-sufficient in milk production now, and most are even less likely to be able to expand domestic production of milk and dairy products to meet expected increased future demand.

Given these changes, exporters and buyers are increasingly looking to the United States to become a significant export supplier of dairy products in the future. This country certainly has the long-term capacity to play such a role in the international dairy economy. Only five countries with established, export-oriented dairy industries appear to have clear-cut cost advantages over the U.S. — New Zealand, Australia, Argentina, Uruguay, and Ireland. In all five, which collectively produce little more than one-third as much milk as the U.S., the domestic milk production systems are predominantly pasture-based. Such systems result in low cost milk production but they are generally unsuited to expansion of production unless additional pasture land or supplies of feed can be developed or bid away from alternative uses at low cost. Argentina would appear to be the only country with the potential to do so.
International Trade Agreements

International trade agreements are likely to play an important role in this evolving international trade picture for the U.S. dairy industry. Of greatest interest, of course, is the eventual resolution of the Uruguay Round multilateral trade negotiations under the General Agreement on Tariffs and Trade (GATT), still uncompleted after six years of negotiations, and the North American Free Trade Agreement (NAFTA), which has been signed but awaits congressional ratification.

Both of these agreements, as well other potential agreements in the future, will impact the U.S. dairy industry in several very broad ways. First of all, they will change the conditions of market access in the U.S. and in other countries subject to the agreements. The conditions of market access mean the extent to which, and the terms under which, domestic dairy markets are open to imports from other countries.

In the U.S., imports of most dairy products are restricted under quotas imposed under the authority of Section 22 of the Agricultural Adjustment Act. U.S. dairy import quotas amount to about 4.3 percent of domestic consumption of cheese, 2.3 percent of domestic consumption of non-fat milk solids and 1.1 percent of domestic consumption of milkfat. Other countries employ similar import control systems. In the European Community and other European countries the mechanism is a variable import levy or tariff. In Canada, Mexico, Japan and certain other countries, it’s an import control or licensing system. The U.S. and other countries also impose ordinary tariffs on dairy product imports.

International trade agreements would also affect the use of export subsidies, which are currently one of the major factors causing distortions in world dairy markets.

The following is a brief description of the changes that NAFTA and a potential Uruguay Round agreement under the GATT would cause from the perspective of our industry in terms of market access, export subsidies and other matters.

NAFTA

Under the NAFTA, Mexico would relinquish its current import licensing requirement for various U.S.-origin dairy products, replace it with ordinary tariffs in the case of cheese and evaporated milk and with an initial 40,000-ton duty-free quota for nonfat dry milk, and phase out all tariffs on dairy products imported from the U.S. over 10 years (15 years for the over-quota tariff on nonfat dry milk).

Since Mexico is one of the world’s major dairy-importing nations, this additional, preferential access for the U.S. dairy industry to that country’s markets would represent the major positive feature of the NAFTA for our industry.

On the other hand, the U.S. would also grant Mexico duty-free quotas on all dairy products currently subject to U.S. import quotas under Section 22. These quota levels for Mexico would start out at a level equal to 5 percent of the current Section 22 quota quantities for all countries, and be expanded at a compounded rate of 3 percent per year. Furthermore, these quotas for U.S. imports from Mexico would themselves be converted to into “tariff-rate quotas,” under which imports would be permitted above the quota levels but would be subject to specified, and initially prohibitive, “over-quota” tariffs. These over-quota tariffs, as well as certain ordinary tariffs on dairy imports, would be entirely phased out over 10 years.

Therefore, as far as tariff and quota restrictions are concerned, dairy trade between the U.S. and Mexico would be almost entirely free of restrictions ten years after the implementation of NAFTA.
Although it is one of the three signatory countries to the NAFTA, Canada did not agree to make any market access concessions in the NAFTA negotiations as far as dairy products are concerned. Thus, the only NAFTA provisions that relate to market access in dairy products are those that will affect bilateral dairy trade between the U.S. and Mexico.

An important NAFTA provision affecting market access involves so-called “rules of origin.” Rules of origin refer to the specific provisions in a trade agreement that determine whether a product produced with the use of imported ingredients or components is considered, for customs purposes, to originate in the country where it was produced, as opposed to the country in which the imported ingredients or components were produced.

The National Milk Producers Federation was able to secure rules of origin in the NAFTA that would largely prevent dairy components that originate in the EC, New Zealand and other countries, including Canada, from being incorporated into products considered to be of Mexican origin. These special dairy rules of origin will not apply to a few products that are currently under Section 22 dairy import quotas nor to certain other Section 22 products if their dairy composition is below certain specified amounts. Furthermore, the rules cannot prevent Mexico from replacing the dairy products it exports to the U.S. under the NAFTA market access agreement with cheaper, subsidized imports from the European Community and other countries. And, as is true of many other provisions, the NAFTA rules of origin for dairy products will not benefit the U.S. dairy industry unless they are strictly enforced. However, overall, the NAFTA rules of origin on dairy products are very tight and should prevent any economically significant circumvention of Section 22 quotas applied to countries other than Mexico.

One of the most important factors that will determine how the NAFTA would affect the U.S. dairy industry is the fact that international dairy markets are heavily distorted through the practice of export subsidization by the EC and other, primarily European, countries. Because of this situation, export subsidies will be required to make many U.S.-produced dairy products competitive in the Mexican market, even though the NAFTA will grant the U.S. certain preferential access to that market.

While the NAFTA provisions on export subsidies do not prohibit U.S. export subsidies on exports to Mexico, this basic economic fact means that the U.S. dairy industry will not automatically be able to realize all potential gains from the NAFTA market access agreement. In fact, it would not be too far-fetched to state that one of the most important factors that would ultimately determine how valuable NAFTA will be for the U.S. dairy industry is the degree to which dairy export subsidies continue to be employed in world trade by non-NAFTA countries. The NAFTA does provide that the U.S. may request consultations to urge Mexico to take action to counter the effect of subsidies used by the European Community and other countries to export dairy products to Mexico. However, it remains to be determined how this provision will apply in practical terms.

The NAFTA also includes provisions relating to the sanitary and phytosanitary standards maintained by individual countries. These provisions essentially require the health-related sanitary and phytosanitary standards maintained with respect to trade between the three NAFTA countries to: 1) be based on scientific evidence, 2) not be applied in an arbitrary or discriminatory manner, 3) be developed based on the principle of risk assessment, and 4) be applied only to the extent necessary to achieve a clearly understood level of protection.

A country would be in conformity with these requirements if it based its standards on those developed by certain international organizations, particularly the Codex Alimentarius Com-
mission. However, the provisions will permit an individual country to maintain sanitary and phytosanitary measures different from, and more stringent than, the relevant international standards as long as there is scientific justification for doing so and as long as the more stringent standard is necessary to maintain a level of protection a particular country determined to be appropriate and is not applied in an arbitrary or discriminatory manner.

One question often raised is whether or not the NAFTA provisions on standards would require the U.S. to weaken its present standards concerning the quality and safety of dairy products as well as animal health in the dairy industry. It is not at all clear whether the NAFTA standards provisions would have this effect, but it is one of the outstanding questions to which we need more definitive answers before we can fully assess the potential costs and benefits of the NAFTA for our industry.

Ultimately, the impact of NAFTA on the U.S. dairy industry would depend upon whether it would result in either a greater volume of net exports of U.S.-produced dairy products to Mexico or a greater volume of net U.S. dairy imports from Mexico and elsewhere. This, in turn, would depend on such factors as the future growth of commercial demand for dairy products in Mexico, how the Mexican dairy industry would respond, changes in world dairy markets, the degree to which the U.S. Administration remains committed to the use of export subsidies to counter EC and other subsidies in the Mexican market, and the effectiveness of the rules of origin in practice. A related issue is whether or not Mexican milk producers will be able to operate at a significant cost advantage compared to our dairy farmers due to lower labor costs, lower environmental compliance costs and a reduction in feed costs as a result of NAFTA. However, most economic studies that have been completed to date indicate that NAFTA will have a positive impact on the U.S. dairy industry.

**Uruguay Round Negotiations under the GATT**

Although no agreement has been reached yet in the Uruguay Round negotiations under the GATT, most of the major agricultural issues have actually been settled for now following a bilateral agreement between the U.S. and the EC last fall. But if the negotiations continue to drag on, this agreement will undoubtedly begin to erode.

A Uruguay Round agreement would also affect the U.S. dairy industry primarily through its provisions on market access, export subsidies and sanitary and phytosanitary standards. Where things stand now under the various Uruguay Round draft agreements in agriculture is roughly as follows:

- Non-tariff import measures, such as import quotas, variable import levies and import licensing requirements would be converted to tariff-rate quotas for which 1) the quota levels would represent at least 3 percent of domestic consumption in the first year of the agreement and at least 5 percent of domestic consumption at the end of a six-year implementation or transition period, and 2) imports above these tariff-rate quota levels would be subject to much higher over-quota tariffs, which would be reduced by a minimum of 15 percent during the six-year implementation period.

- Furthermore, under the draft Uruguay Round agreements, the “Section 22 waiver” which allows the U.S. to impose dairy import quotas under the authority of the U.S. Section 22 law without being inconsistent with current GATT rules, would be terminated.
• Also, and very significantly, expenditures used to subsidize exports of agricultural commodities would be reduced from their average levels during the period 1986-90 by 36 percent over the six-year transition period and quantities of agricultural commodities exported with the aid of subsidies would be reduced from their average levels during the period 1986-90 by 21 percent over the six-year implementation period.

Based NMPF’s analysis, implementation of these market access and export subsidy provisions, as specified in the specific offer the U.S. has made in the negotiations, would have the following effects on the U.S. dairy industry at the end of the six-year implementation period: Compared with current dairy imports, imports of additional milkfat totalling .4 billion lbs. milk equivalent, additional nonfat solids totalling .2 billion pounds milk equivalent, and additional cheese totalling .4 billion pounds milk equivalent, would be permitted under the “minimum access” provisions of the U.S. offer through expanded tariff-rate quotas, based on current Section 22 import quotas. In total, additional dairy market access opportunities would total 1.0 billion pounds milk equivalent, compared with current import levels of about 4 billion pounds milk equivalent, with all milk equivalents expressed on a total solids basis; (expressed on a milkfat basis, additional market access opportunities would total 1.4 billion pounds compared with current imports of about 2.6 billion pounds milk equivalent).

Imports of dairy products above these tariff-rate quota levels are possible, but cannot be predicted with any confidence; such imports would depend upon changes in the supply-demand conditions in the U.S. dairy industry and the dairy industries of a number of other countries, changes in world prices, exchange rate fluctuations, and other factors.

Subsidized exports of about .4 billion pounds milk equivalent, of butter and butter oil, slightly more than 1.0 billion pounds milk equivalent, of nonfat dry milk, about 40 mil. lb. of bovine meat, and about 11,400 dairy cows would be permitted by the end of the transition period.

However, such an agreement would also open up additional access to dairy markets in the EC, other European countries, Canada and other countries to U.S. dairy exports. And undoubtedly the single most important benefit to the U.S. dairy industry under as potential Uruguay Round agreement would be the significant reduction in volumes of dairy products exported with the aid of subsidies by the EC. Stronger disciplines on the use of export subsidies would increase world dairy product prices and free up a substantial amount of export demand that is currently being served by the EC through the use of subsidies. Quantitative estimates of these potential positive impacts of a Uruguay Round agreement on the U.S. dairy industry have not yet been developed.

The Uruguay Round draft agreements also contain new rules on sanitary and phytosanitary measures. In the main, these are very similar to the NAFTA provisions on standards. Indeed, the provisions on standards contained in the NAFTA, for which negotiations were begun several years after the Uruguay Round negotiations were launched, were modelled largely on the draft provisions on standards that had been developed several years ago in the GATT talks.

**Final Comment**

An eventual Uruguay Round agreement, the North American Free Trade Agreement, as well as potential future bilateral trade agreements with Latin American and Asian countries would provide additional access for U.S. dairy exports to other countries. Under such trade agreements, U.S. dairy markets will also gradually become more open to additional imports. Overall, the U.S. dairy industry, along with other agricultural sectors, will face an increasingly open world trading system in the future.
References:


