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# **European Union**

## **Dairy and Products**

### **Semi-Annual**

### **2002**

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#### **Report Highlights:**

**The year 2002 is a year of turmoil for the EU dairy sector: higher production of SMP and butter is sold directly into intervention and exports are lagging. Next year should see an improvement of export prospects, due to improved demand and changes in export patterns for some products.**

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Includes PSD changes: Yes

Includes Trade Matrix: No

Semi-Annual Report

Brussels USEU [BE2], E2

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For trade policy issues, such as double zero and double profit agreements, please refer to the 2002 EU Annual Dairy Trade Policy Report (#E22058).

## **EXECUTIVE SUMMARY**

The EU dairy situation in 2001 was contradictory: consumption of some dairy products, particularly cheese, boomed because of the BSE crisis and world prices were good, which reduced restitutions expenditures. On the other hand, the FMD outbreak brought trade to a virtual standstill and complicated production decisions. Many producers foresaw a decrease in milk availability throughout the EU because of culling schemes linked to animal disease outbreaks and increased production of dairy products accordingly. Unfortunately for these producers, most animals were not culled but rather retained on farm in the hope of better prices. Therefore production never went down and stocks started piling up as of the end of 2001. Demand in world markets slowed down almost at the same time. This brought about a very difficult situation in 2002, with lagging exports, stable consumption and processors opting for "safe" products, i.e. SMP and butter which could be sold to intervention. It is forecast that 2003 should see an improvement for the EU dairy sector. Demand in world markets is expected to resume around the end of 2002 while production adjusts to balanced lower levels, especially for butter and SMP. This should bring about a slow reduction of intervention stocks. Imports are steadily growing, due to the conclusion of double zero followed by double profit agreements liberalizing most dairy trade between the EU and the 10 Central and Eastern European countries.

**FLUID MILK**

PSD Table						
Country:	European Union					
Commodity:	Dairy, Milk, Fluid			(000mt)		
		2001		2002		2003
	Old	New	Old	New	Old	New
Calendar Year Begin		01/2001		01/2002		01/2003
Cows In Milk (000 head)	18238	17857	18198	17703	0	17460
Cows Milk Deliveries to Dairies	117875	114655	117400	114531	0	114450
Other Milk Production	2425	2302	2445	2330	0	2370
TOTAL SUPPLY	120300	116957	119845	116861	0	116820
Fluid Use Dom. Consum.	32553	32445	32522	32237	0	32120
Factory Use Consum.	87747	84512	87323	84624	0	84700
Feed Use Dom. Consum.	0	0	0	0	0	0
TOTAL DISTRIBUTION	120300	116957	119845	116861	0	116820

Note:

1. The discrepancies between old and new columns result from the fact that the old columns represent total milk production (milk deliveries+on farm use+direct sales) while the new ones represent deliveries to dairies. Milk deliveries represent more than 90 pct of total

EU milk production and are deemed to reflect more accurately the trends in the EU dairy sector, as reference figures are more reliable. Consequently, feed use consumption is no longer reported as it provides an outlet for milk used on farm, and not milk delivered to dairies. End note.

In 2001, EU quota-managed dairy production followed a traditional decreasing pattern which is expected to continue in 2002 and 2003. The quota increases granted to some member states in 2000/01 and 2001/02 basically reflected existing production and only deflated superlevy fines paid on oversupplies rather than augment milk deliveries. Furthermore, the constant increase in fat content in EU milk contributes to pushing down actual quantities delivered to dairies to the quota limit. However the decline in production is limited, as EU farmers faced with low dairy prices in 2002 still want to optimize their allowed quantities and use up their individual quotas.

Other milk production (goat, sheep, buffalo) still represents about 2 pct of total EU milk production and tends to increase slightly over the years, mainly in France and Italy. This can be explained by the fact that other milk production is not covered by production quotas and offers a valuable source of income especially in difficult mountainous areas.

Fluid use is fairly stable in the EU, mainly thanks to continued good marketing prospects for flavored milks. Factory use, on the other hand, is constantly increasing, as ready-made meals and restaurant eating become increasingly popular with EU consumers.

**CHEESE**

PSD Table						
Country:	European Union					
Commodity:	Dairy, Cheese		(000mt)			
		2001		2002		2003
	Old	New	Old	New	Old	New
Calendar Year Begin		01/2001		01/2002		01/2003
Beginning Stocks	1194	1131	1142	1170	0	1137
Production	5929	6044	5953	5989	0	6000
Extra EC Imports	150	143	164	149	0	154
TOTAL SUPPLY	7273	7318	7259	7308	0	7291
Extra EC Exports	452	446	451	450	0	447
Human Dom. Consumption	5419	5417	5472	5445	0	5500
Other Use, Losses	260	285	262	276	0	263
TOTAL Use	5679	5702	5734	5721	0	5763
Ending Stocks	1142	1170	1074	1137	0	1081
TOTAL DISTRIBUTION	7273	7318	7259	7308	0	7291

Cheese production boomed in 2001 as the BSE crisis led many EU consumers to replace some of their animal protein intake from beef and meat by cheese. Cheese producers felt the domestic demand and increased production to a considerable extent. Unfortunately, this switch in consumption was short-lived and EU consumers went back to meat as of the summer of 2001. Production of cheese is thus likely to shrink in 2002 compared to 2001, as no EU intervention scheme is available to absorb cheese oversupply (the private storage aid scheme only applies to some Italian and Swedish cheeses and limited quantities of Emmental). Cheese production is forecast to show some recovery in 2003, as producers move away from butter and SMP production which is ending up in intervention stocks.

After the big boom of 2001, EU consumption of cheese returns to more normal growth levels. However, consumption gains recorded in 2001 remain and later consumption growth builds upon levels reached in 2001. This is due to increasing demand for cheese in processed ready-made foods.

Exports of cheese are stable. Export refunds were increased in May 2002, but boosting effects on exports are still uncertain. In spite of unchanged levels of exports, patterns of EU cheese exports are changing. First of all, unsubsidized exports of cheese are constantly increasing, amounting to about

170,000mt in 2001. EU cheese is now exported to 22 countries without restitutions because of free trade agreements. Even restitutions on cheese to the United States have been cut several times and are now minimal. Among traditional EU cheese exporters, the Netherlands is now moving away from bulk cheese into specialty cheese exports and thus reducing quantities. Germany can now be seen as the major EU exporter of bulk cheese, mainly to Russia, also supplied by Finland. France exports mainly to Saudi Arabia and Switzerland.

Imports of cheese are experiencing steady if limited growth, due to the effects of double profit agreements with Central and Eastern European countries (CEECs).

**BUTTER**

PSD Table						
Country:	European Union					
Commodity:	Dairy, Butter		(000mt)			
		2001		2002		2003
	Old	New	Old	New	Old	New
Calendar Year Begin		01/2001		01/2002		01/2003
Beginning Stocks	294	163	333	170	0	211
Production	1717	1671	1668	1683	0	1650
Extra EC Imports	82	102	86	104	0	104
TOTAL SUPPLY	2093	1936	2087	1957	0	1965
Extra EC Exports	135	138	140	130	0	145
Domestic Consumption	1625	1628	1620	1616	0	1614
Total Use	1625	1628	1620	1616	0	1614
Ending Stocks	333	170	327	211	0	206
TOTAL DISTRIBUTION	2093	1936	2087	1957	0	1965

Note: Discrepancies between old and new beginning stocks is due to adjustments made to statistical data on Dutch, Italian and Swedish stocks. End note.

In 2001, butter production decreased as a consequence of larger quantities of milk processed into cheese. As of the end of 2001, cheese consumption began to stagnate and producers hurriedly switched to butter and SMP manufacturing. Many industrial users of butter had expected a shortage of butter after the FMD outbreak and had stocked butter at the beginning of the year. The resumption of butter production coincided with the release of private stocks and caused prices to plummet which in turn triggered intervention. By June 2002, intervention stocks had reached 250,000mt. In 2003, butter production is expected to shrink again, due to stagnating exports and consumption and to large intervention stocks exerting pressure on prices.

Butter consumption has been decreasing for years and is expected to continue to do so. The largest consumption EU aid scheme for butter, selling low priced butter to ice cream and pastry manufacturers amounts to about 475,000mt of butter per year and has remained fairly stable over the years.

In spite of increased export refunds, EU butter exports are experiencing a slight decrease in 2002 due to lack of competitiveness with Oceania exporters. However, exports should fare slightly better in 2003 due to improved prospects for German butter to Russia.

Imports of butter are growing slowly, due to the conclusion of double zero agreements.

**SMP**

PSD Table						
Country:	European Union					
Commodity:	Dairy, Milk, Nonfat Dry			(000mt)		
		2001		2002		2003
	Old	New	Old	New	Old	New
Calendar Year Begin		01/2001		01/2002		01/2003
Beginning Stocks	160	154	190	196	0	240
Production	965	940	965	992	0	950
Extra EC Imports	94	82	96	82	0	82
TOTAL SUPPLY	1219	1176	1251	1270	0	1272
Extra EC Exports	166	140	211	180	0	205
Human Dom. Consumption	330	340	302	330	0	330
Other Use, Losses	533	500	536	520	0	520
TOTAL Use	863	840	838	850	0	850
Ending Stocks	190	196	202	240	0	217
TOTAL DISTRIBUTION	1219	1176	1251	1270	0	1272

EU SMP production, much like butter, diminished in 2001, following the surge in cheese production, and resumed again in 2002 after the cheese market slowdown. The level of mandatory incorporation of SMP in the EU subsidized feed scheme was restored to 50 pct at the end of 2001, which should increase its use in feed. Much of the SMP produced in 2002 is being directly sold into intervention, as in Ireland, or is being stockpiled in anticipation of renewed domestic demand for feed following the slow resumption of cattle production. SMP intervention opened in March 2002 for the first time since 1999 and started absorbing considerable quantities. The legal ceiling of 109,000mt was reached in June 2002 and intervention was then replaced by tenders, leading to a further decline in prices. As markets realign themselves in 2003, it is expected that SMP production will decline again as markets are burdened by high intervention stocks. However, production in 2003 is forecast at a level slightly above that reached in 2001 as a result of improved export prospects and sustained demand for feed.

As outlined above, consumption of SMP in feed is foreseen to increase in line with growing cattle numbers while human consumption is declining marginally as a consequence of growing use of fluid milk instead of SMP recombination. An illustration of this is the 2002 drop of traditional exports of Spanish SMP to the Canary Islands for recombination.

EU SMP exports were low in 2001, as export restitutions were first reduced and then suppressed in order to prevent a shortage of SMP in the domestic market. Exports are only recovering slightly in

2002 in spite of massive restitutions increases throughout the year, due to lack of demand in world markets. It is forecast that demand will grow in international markets around the end of 2002, which, in combination with high export refunds, will improve EU SMP exports in 2003. However, because of fierce competition with Oceania producers, the recovery will not be significant enough to drastically reduce intervention stocks by the end of the year.

Imports remain stable and result from the implementation of double zero agreements.

The discrepancy between the recovery of SMP production in 2003 to 2001 levels and the still declining butter production in the same year is due to expected larger production of casein, thanks to higher processing aid rates.



**WMP**

PSD Table						
Country:	European Union					
Commodity:	Whole Milk Powder (WMP)		(000mt)			
		2001		2002		2003
	Old	New	Old	New	Old	New
Calendar Year Begin		01/2001		01/2002		01/2003
Beginning Stocks	62	59	54	70	0	57
Production	870	840	870	822	0	840
Extra EC Imports	5	7	5	7	0	8
TOTAL SUPPLY	937	906	929	899	0	905
Extra EC Exports	523	438	519	450	0	463
Human Dom. Consumption	280	284	275	279	0	275
Other Use, Losses	80	114	75	113	0	112
TOTAL Use	360	398	350	392	0	387
Ending Stocks	54	70	60	57	0	55
TOTAL DISTRIBUTION	937	906	929	899	0	905

Note: Discrepancies between old and new losses and production figures are due to corrections of anomalies in France. End note.

EU production of WMP in 2001 declined as a result of the FMD outbreak and poor export prospects which in turn inflated ending stocks. In 2002 production is declining further in line with growing SMP and butter production. Slightly recovering exports bring intervention stocks back to more traditional levels. It is foreseen that production will recover in 2003 as processors turn away from SMP and butter production. Intervention stocks remain stable while exports are boosted by higher export refunds.

Exports were affected by the FMD outbreak in 2001, as well as a steep decrease of export refunds. New Zealand took over major export markets from EU member states, France in particular, in 2001. As intervention stocks grew larger and restitutions were increased in 2002, exports to traditional destinations such as the Near and Middle East, Cuba and Latin America recovered and are expected to continue to do so in 2003.

Imports are and remain minimal.

## MID-TERM REVIEW

When Agenda 2000 was adopted in 1999, the Council requested that the Commission undertake a mid-term review on the implementation of certain provisions of the agreement, including milk quotas, and, if necessary, make proposals for adjustments. The review of the dairy provision was initially scheduled for 2003, but brought forward to 2002, given its close link to the beef sector. As Agenda 2000 measures will only enter into force for the dairy sector as of 2005 and the quota system has already been extended until 2008, this mid-term review will look at options for the sector after 2008.

The Commission will publish its entire mid-term review on July 10, 2002. Afterward, depending on Council reaction, the Commission may propose changes in the CAP based on the review. In some parts of the EU dairy sector, it is speculated that the current imbalance in the dairy sector will give rise to further changes in the dairy system as of 2005 beyond the current Agenda 2000 reforms. However, publicly, the Commission is currently looking at changes only beginning in 2008, after the legal end of the quota system.

A Commission working document, aimed at stimulating debate on the future of the regime, reviews the current dairy situation and also proposes for different scenarios for reform in 2008. The dairy situation in the Central and Eastern European countries is not taken in account in this report.

The first scenario takes a look at how the market would develop under a simple extension of the Agenda 2000 status quo. The second option looks at further lowering intervention prices and increasing quotas along the lines of the Agenda 2000 approach. The third scenario is a two-tiered quota approach, along the lines of the Canadian system. Finally, the fourth scenario is total quota elimination.

Although the report does not clearly favor any of the four options, it does warn against possibly unmanageable effects of option 4 and potential WTO incompatibility of option 3. It also emphasizes that the positive effects of option 1 will fade away rapidly as of 2008. It appears fair to say that option 2 seems the most adequate to balance EU dairy markets in the long term. It should be remembered that when Agenda 2000 was initially discussed, one of the options supported by the "liberal" member states (eg., UK, Sweden.) was a 30 pct cut in butter and SMP intervention prices and a 4 pct quota increase. It was assumed then that a 30 pct cut would put EU prices at world price level for butter and SMP.

**Simple extension of the Agenda 2000 status quo until 2015** - The Agenda 2000 agreement is a 15 pct cut in butter and SMP intervention prices to be compensated by direct payment per ton of milk quota and a slight increase of reference quantities. It should be pointed out that the report suggests that an asymmetric intervention price cut of 25 pct for butter and 5 pct for SMP would have been more appropriate.

After 2008, it is assumed that markets are balanced and stocks remain low, which results in low

expenditures on consumption schemes and export refunds for butter and SMP. Dairy cow numbers continue to decrease, which improves the beef market balance. Negative aspects are reduction in exports until they become virtually non-existent for non-competitive products such as butter. But more interesting is significantly lower levels of exports for cheese.

The report also muses that any relief generated by Agenda 2000 reforms would be lost with a constant quota from 2008, onward. It theorizes that the sector returns to an inflexible state by being locked in by quotas.

**Lowering Support Price and Increasing Quotas** - This option is an acceleration of Agenda 2000 measures, i.e. larger asymmetric cuts in intervention prices (15 pct for butter and 5 pct for SMP) and a 3 pct increase in quotas. As with the first option, after 2008, the report forecasts market balance and budget cuts for butter and SMP consumption schemes and export refunds. Additionally, an increase of unsubsidized exports and lower consumer prices resulting from quota rent cuts would pave the way to the lifting of the quota regime. However, an extended Agenda 2000 scenario would still burden EU budgetary expenditures and not get rid of systemic economic inefficiencies.

**Two-tier quota regime** - This option is analogous to the Canadian milk quota system. The Commission's report expresses reservations of this type of system, given the scrutiny the Canadian system is receiving in the WTO.

Under this scenario, domestic quota would be reduced to the level of unsubsidized domestic consumption (A quota) along with an open, independently managed quota for exports (C quota). The report states that this scenario would assure market balance. In addition, exports would increase, export refunds and consumption aids by definition would be eliminated and intervention and private storage aid costs would decline. However, the question of WTO compatibility remains and the implementation system would require considerable administrative costs. Also, the report questions the actual ability for such a system to work under current EU commercial conditions.

**Total abolition of the quota system.** This scenario would remove the economic burden of quotas for potentially efficient farmers and the cost of market support measures from consumers. However, the alleged fall in prices would not systematically increase market opportunities for milk and the socio-economic consequences on the sector are difficult to assess.