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Frank H. Fuller  
Iowa State University, ffuller@iastate.edu

John C. Beghin  
Iowa State University, beghin@iastate.edu

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Global Prospects for Dairy in Argentina and Chile and Lessons for U.S. Dairy Industries

Frank Fuller  
ffuller@iastate.edu  
515-294-2364

John Beghin  
beghin@iastate.edu  
515-294-5811

In contrast to the Uruguay Round Agreement on Agriculture of the World Trade Organization (WTO), a successful Doha Round of WTO negotiations is likely to bring major changes in international dairy markets. Some countries protect their domestic producers by using restrictive tariff rate quotas (TRQ) and high over-quota import duties. And large export subsidies allow the European Union and other countries to continue to export dairy products despite high internal price supports.

The significant tariff cuts and elimination of export subsidies currently proposed in the Doha negotiations would create notable shortages in international dairy markets in the near term. Rising world prices will undoubtedly generate a supply response in countries with historically strong dairy industries, such as New Zealand and Australia, but it is less clear which other countries will step up to fill the void created by the removal of subsidized products and meet market opportunities created by lower tariffs. Argentina and Chile are two potential beneficiaries of a new WTO agreement. We review key findings of a recent CARD study on these two countries’ dairy sectors and draw lessons for U.S. dairy.

Argentine Dairy: Strong but with Continuing Challenges

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Argentina has a century-old tradition of dairy production. In 1999, Argentina was 13th in global milk production, right behind New Zealand. In that same year, Argentina was a major exporter of whole milk powder and a growing exporter of cheese. The economic crisis in 2001 prompted a severe contraction of dairy production. The sector has emerged from the crisis as a viable industry with tremendous potential.

Argentine Dairy has a competitive processing sector dominated by a number of large firms with a clear export orientation. Many of the top firms have long been involved with export markets and have built brand recognition in foreign markets. Moreover, the connections between domestic firms and international partners, such as Nestlé, Fonterra, and Saputo, give Argentine processors access to expanded marketing expertise abroad. These processors have proven they have the ability to meet international consumers’ demand for quality and product safety.

The road infrastructure in Argentina is excellent, even in remote areas. This is in sharp contrast to Brazil and, to a lesser extent, Chile. The transportation and communication infrastructures seem more than adequate to allow quick price discovery and easy communication between the processors and farmers for sample test results and other marketing matters. Pricing incentives are already in place to pay farmers for low bacteria counts, high fat, and high milk-solid content.

Despite these advantages, Argentina’s dairy sector faces significant challenges in expanding its production and exports. Since the financial crisis, a great source of uncertainty for investors in Argentina has been the instability of the Argentine currency and the threats of price control. The peso underwent a massive devaluation in 2002. The peso is now expected to appreciate in real terms against the U.S. dollar because of relatively high inflation in Argentina. Competitiveness based on the massive devaluation will be progressively eaten away by inflation. Argentina’s domestic and trade policies add to the uncertainty for dairy producers. Argentina
imposes a 15 percent export tax on most dairy products, handicapping the industry. Value-added-tax refunds on exports were eliminated as well after 2001. The government has a history of adjusting the export tax rate as international prices change, and this discretionary approach to taxation adds to the uncertainty of future profitability for dairy producers and processors.

The export tax raises government revenues and lowers the cost of food for urban constituencies. Exports are a convenient source of fiscal resources. In addition, the government has threatened to impose a price freeze on dairy products, effectively resulting in administered price controls. These tactics have been employed in other agricultural sectors, most notably in beef. Price controls on consumer products have ripple effects; processors are then forced to lower raw milk prices to offset their lost sales revenue. The negative impact of these disastrous policies is seen in Argentina’s country risk rating, which is among the worst in Latin America. Market access issues, mostly tariffs and TRQs, are the primary barriers to Argentine dairy exports. Argentina exports milk powder to OPEC countries (Algeria, Iran, Iraq, and Nigeria) that tend to have relatively low duties on powder. For example, Algeria applied a 5 percent duty on milk powder products. Subsidized products, primarily from the European Union, have some negative impacts on Argentina’s potential foreign sales because Argentine exports compete with EU exports.

**Chilean Dairy: Poised for Growth**

Over the last two decades, the government of Chile has been committed to an open economy, which has led to extremely low tariffs by international standards, increasing competitiveness in export-oriented and import-competing sectors and to significant integration into world markets. As a result, Chilean agriculture has shown remarkable growth, both in terms of total value and productivity. The growth in agricultural exports is double that of the country’s GDP growth, approximately 10 to 12 percent annually. The central valleys of Chile, with their temperate conditions and dry summers, produce most of the high-valued agricultural products. In the southern Los Lagos (10th) region, where roughly 70 percent of Chile’s milk is produced, the climate is wetter, supporting lush grasslands and pasture. However, the bulk of Chile’s population and demand for dairy products is further north in the Santiago area. Consequently, much of the milk produced in the south is processed for transport north as milk powder or shipped to export destinations. Only roughly half of the pasture resources in the 10th region is currently used, so there is great potential for substantial growth in dairy production.

Historically, Chile has been a small net importer of dairy products. In 2004, Chile became a net exporter of dairy products. While making this transition from importer to exporter, Chile’s dairy production lost natural protection from tariffs and from the costs of international transportation. A reduction in milk and dairy prices occurred in Los Lagos early in the decade, and milk production costs are now at levels that are competitive on world markets. Chile’s pursuit of free trade agreements has opened doors for its dairy industry in foreign markets. The country has become the largest exporter of hard cheeses to Mexico, shipping roughly 18,000 metric tons of cheese annually under its preferential agreement. The agreement with China in 2005 is expected to lead to an increase in China’s imports of Chilean whey powder in the near term and in cheese imports after five years.

Chile’s 10th region shares many characteristics with the dairy areas in New Zealand. However, Chile’s dairy sector has been oriented toward non-seasonal production for decades to provide a steady supply of milk and dairy products to Santiago and other population centers. If Chile is to expand its influence on international dairy markets, the dairy industry will need to embrace a more export-oriented approach to production and marketing. This will require investment so that dairy farms can upgrade to meet international quality standards. Chile currently lacks the financial and support services necessary to modernize its dairy operations, particularly using seasonal production, which is popular in New Zealand. Farmers find it difficult to secure financing for investments and for working capital. Likewise, the local insemination, veterinary, and contract labor systems needed for efficient management of a seasonal dairy operation are not in place. Milk-processing capacity is near full utilization, and additional capacity currently under construction is partially offset by the closure of a number of small cheese plants. In contrast to Argentina, Chile is a safe and profitable investment location and receives the best risk
expansion are not the most cost-efficient means of maintaining the status quo.

All evidence suggests that high premium subsidies are needed to induce farmers to join the program. The overall cost of these subsidies could be reduced if the structure of premium subsidies was changed to decrease the incentive for farmers to buy the most expensive forms of crop insurance. We previously estimated that $300 million could be saved by such a move.

Significant savings could also be obtained by changing the way that A&O subsidies are determined. Most of these funds are captured by crop insurance agents. But given the growing familiarity of farmers with the program and the currently large market penetration of insurance, do we need to continue to pay large commissions simply to maintain farmers in the program? One alternative is to pay a commission directly to those farmers who sign up for crop insurance through the Internet or directly with RMA. Recent political battles between agents and innovative companies over premium reduction plans that allow farmers to capture a portion of agent commissions indicates how difficult it would be to wean the industry away from the status quo of high commissions.

Considerable savings could also be obtained by making underwriting gains and losses the sole responsibility of the federal government. As illustrated here, the compensation required to induce companies to take on a small amount of risk (relative to the gains that they obtain) is large. We estimate that taxpayers would benefit by an average of $435 million per year if USDA directly underwrote all risks from the crop insurance program. A potential downside from having the government underwrite all risk is that companies would lose the incentive they now have in their retained business to prevent fraud. ◆

ratings in Latin America. The presence of Nestlé and Fonterra in Chile may provide some of the financial resources needed to promote a general increase in production scale and accelerate the rate of technology adoption.

Our research suggests that the reduction of tariffs and elimination of subsidized dairy exports in a new WTO agreement will increase milk production in Argentina and Chile by 7 and 4 percent, respectively, over expected production under current policies. Argentine milk powder exports will increase by more than 20 percent, and cheese exports will rise more than 50 percent. Similar impacts are projected for Chilean whole milk powder and cheese exports. However, the expansion of Argentine dairy trade will be significantly lower if the government does not eliminate its taxes on dairy exports.

International Prospects for U.S. Dairy Industries

These two case studies shed light on U.S. dairy prospects in global markets. The U.S. dairy industry combines most of the sources of competitiveness characterizing its two South American competitors: availability of inexpensive feed and land in many regions suitable for dairy production, high human capital, access to modern technology, an efficient processing sector, excellent transportation and communication infrastructures, low capital cost and credit risk, and a tradition in dairy production. So it is puzzling that the United States does not export more dairy products. The current U.S. dairy program, with its price distortions and border impediments, obscures the international competitiveness of U.S. dairy and provides producers with incentives to cater to domestic rather than to foreign markets. Reducing these domestic incentives would force the U.S. dairy industry to turn outward, where it is well equipped to be internationally competitive in world markets, especially if all countries reform their own distorting policies. ◆