Intelligence MEMOS

From: Dan Ciuriak

To: Canadian Trade Watchers

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Re: **Industrial Policy Lessons from a Dairy Pot Calling Canada's Kettle Black**

Industrial policy is very much in vogue these days as major economies battle to dominate the key battlegrounds of artificial intelligence and the supporting technological infrastructure of data and computer chip manufacturing; biotechnology; and green-tech manufacturing.

The full arsenal of industrial policy tools has been mobilized, including subsidies galore, tariffs that scale heights reminiscent of the 1930s trade wars, and weaponization of supply chains.

And away from the main fray, other frictions fueled by industrial policies are being litigated under still-functioning dispute settlement mechanisms in regional trade agreements. In particular, the US and New Zealand have challenged Canada's administration of the dairy quotas negotiated under the Canada-US-Mexico Agreement (CUSMA) and under the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) respectively.

Legal issues aside, these cases are important from another perspective: They point to the dairy policies of some key trading partners as examples of failed industrial policy.

The US supports excess dairy capacity by buying up unlimited amounts of butter and cheese stocks to keep its dairy farmers in business as I've documented elsewhere. This is expensive given near-record levels of cheese and butter – almost 175,000 tons last month for butter – in cold storage and it would prefer to export this problem.

The more interesting case is New Zealand, which has become a dairy export powerhouse in an industry that does not scale at the primary producer level (the farm), and experiences slow demand growth driven mainly by global population growth. So how did New Zealand, a country comparable in many ways to British Columbia, pull this off? It did so through an industrial policy that created a national champion dairy processor, Fonterra, which benefits from an administered price for its farmgate purchases that allows it to set its export price at globally competitive levels to capture export market share, regardless of the marginal cost of milk in New Zealand. In other words, through a government-sponsored subsidy scheme

Fonterra is a farm cooperative and dairy processor, the offspring of the amalgamation of New Zealand's two main dairy cooperatives and the New Zealand Dairy Board, which was the nation's sole statutorily authorized dairy exporter. This amalgamation took place pursuant to the *Dairy Industry Restructuring Act,* 2001 (DIRA).

Since Fonterra is a near monopsony of New Zealand raw milk, there is no "market" price. Instead, the price that Fonterra pays for raw milk ("farmgate milk price") is statutorily set under the DIRA as Fonterra's export price minus costs and margins. Export prices, costs and margins are set using formulas based on hypothetical scenarios that, as I detail here, understate Fonterra's revenues (by assuming all production and exports are commoditized products) but overstate its operating margin (by maintaining the higher margins associated with higher-value products facing more market risk). As a result, the amount Fonterra pays farmers under the DIRA is, by design, structurally lowered while its profit is structurally raised and guaranteed.

While the farmers, as shareholders of Fonterra, receive a payment in dividends to share in this guaranteed profit, such payments are unrelated to their production costs – high-cost farmers receive the same dividends as low-cost farmers. Accordingly, this pricing regime divorces the returns to farmer/shareholders from the marginal cost of producing raw milk in New Zealand.

Thanks to the DIRA price setting, while New Zealand's primary dairy producers face a rising cost curve, Fonterra itself does not. Its profit maximization strategy under this pricing scheme is, accordingly, to maximize its production, which is limited only by its ability to collect milk. This is why Fonterra lobbied for – and New Zealand's parliament granted – DIRA amendments that effectively block farmers from leaving Fonterra.

This export-oriented strategy, building on New Zealand's natural comparative advantage in dairy, appeared to work like a charm, especially when dairy production scaled up following its free trade deal with China.

But since then, the scheme has unravelled, as fast-rising Chinese production coincides with a fall in world dairy prices and Fonterra's market capitalization has shrunk from $11.1 billion US in 2013 to just $3.47 billion at time of writing.

Meanwhile, although the Fonterra price plus dividend falls short of what would be a market price for farm gate milk, farmers are still forced to keep subsidizing Fonterra exports with milk at below-market prices under the DIRA.

Consequently, the government finds itself litigating additional market access under the CPTPP to eke out marginal gains in Canada's small market.

So, what lessons can we draw from New Zealand's remarkable dairy venture? Its industrial policy fuelled an export industry that expanded beyond sustainability, and one now dependent on continued subsidization that is, incidentally, prohibited under WTO rules. The story of Fonterra is a morality tale for

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