Over the Fence

3 May 2019

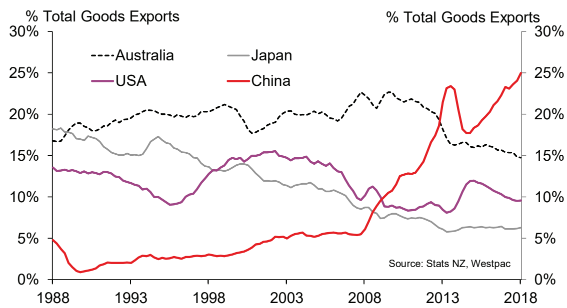
China - not a one way bet

In this inaugural issue of *Over the Fence*, we take a look at the growth in New Zealand's agricultural exports to China, and discuss some of the opportunities and challenges this evolving relationship presents for New Zealand's primary exporters.

- New Zealand's exports to China have surged over the last decade.
- While New Zealand's Free Trade Agreement with China has played a role, the growth in the Chinese population, higher incomes and the changing preferences of Chinese consumers have all been important drivers of this lift in demand.
- Fluctuations in domestic production in China will also be an important influence on demand.
- While there are clearly opportunities for New Zealand exporters to prosper from these developments, it won't all be plain sailing.

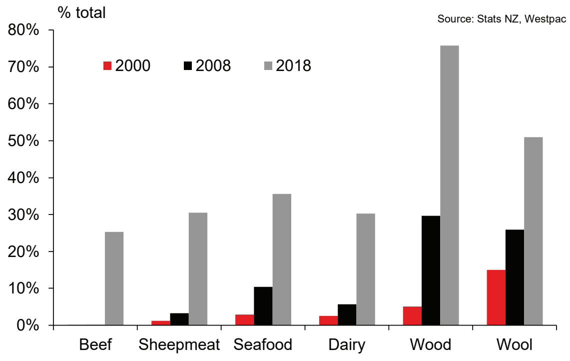
New Zealand's trade with China has surged since the two countries signed a Free Trade Agreement in 2008. On the export side of the ledger, New Zealand's goods exports to China have grown 450%, while visitor numbers from China have more than tripled. China now takes around 25% of all New Zealand goods exports, far eclipsing our second largest export destination (and traditional dominant export partner) Australia.

NZ major trading partners



New Zealand's agricultural exporters are amongst those to have seen the strongest growth in exports to China with China now the largest market for New Zealand dairy, wood, meat, and seafood exports.

Exports to China

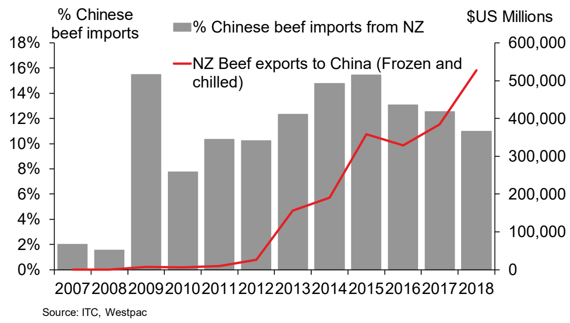


New Zealand benefitted from being the first developed country to sign a Free Trade Agreement with China. But this competitive advantage has been eroded as China has continued to negotiate and sign trade deals with a number of other countries. Indeed, New Zealand and China are currently in the process of negotiating an upgrade to the current agreement with New Zealand attempting to get a better deal on services exports, further tariff reductions and more favourable regulatory and compliance requirements.

Despite our small size, New Zealand is the sixth largest source of China's agricultural and food imports, accounting for around 5% of China's food and agricultural imports in 2018[1].

And while New Zealand's food exports to China have been growing rapidly, Chinese demand for food and agricultural products has been growing even faster. For example, New Zealand's beef exports to China have grown 240% in five years, but that has not been fast enough to prevent our market share of imports from dropping.

Beef trade with China



The biggest drivers of Chinese demand for New Zealand's agricultural products have been population and income growth , as well as changing dietary preferences.

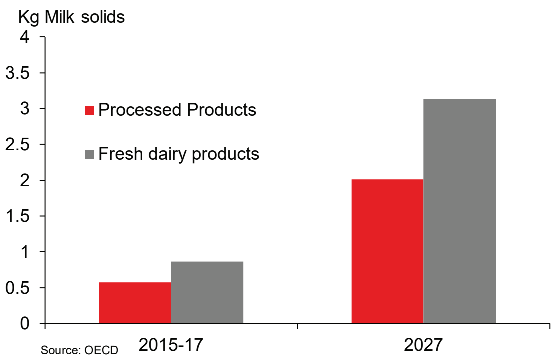
China is home to 1.4 billion people, almost 20% of the world's population. However, the rate of growth in China's population has slowed as fertility rates have declined on the back of the one child policy. The pace of population growth is projected to slow further over the coming years which combined with an aging population could weigh on consumption growth. The OECD forecasts that by 2027 slowing population growth in China means India will overtake China as the most populous country in the world.

Income growth in China has also been very strong on the back of strong economic growth through much of the 2000s. Wealthier households are willing and able to pay more for New Zealand's food exports which often command a premium compared to local products.

This strong growth has seen China become the second largest economy in the world (behind the US). However, most recently growth in China has slowed and the broader outlook is for Chinese GDP growth to linger around 6% per annum (we're forecasting 6.1% this year and 6% next year). While that's very strong by most countries' standards, it's notably slower than the pace of growth we observed over the previous decade (albeit when the absolute size of the Chinese economy was much smaller).

Urbanisation and globalisation of diets has also boosted demand for new foods that have not traditionally been popular in China. And with population growth set to be less of a driver of demand going forward, changing tastes and preferences are likely to become increasingly important determinants of demand, as will growth in exports of higher value products.

Per capita Chinese consumption of dairy products



When considering China's role in global markets, it can sometimes be easy to view China only as a global importer and consumer. However, China is also a big producer of many agricultural commodities in its own right. The Food and Agriculture Organisation reports that China ranks first in the world in terms of the production of cereals, cotton, fruit, vegetables, meat, poultry, eggs and fishery products.

Consequently, fluctuations in local supply within China can have a significant influence on demand for imports. For example, the melamine scandal in 2008 saw demand for imported dairy products soar. Likewise, the recent outbreak of African Swine Fever in China is likely to lead to a significant decline in Chinese pork production, increasing demand for imported pork and also substitute proteins such as beef and lamb.

Chinese domestic agricultural policy is also important. In recent years Chinese policy makers have been focused on supply-side reform of the Chinese agricultural sector. This has included increasing the size of farms, industrialising agricultural production and improving the quality and safety of domestic production. There have

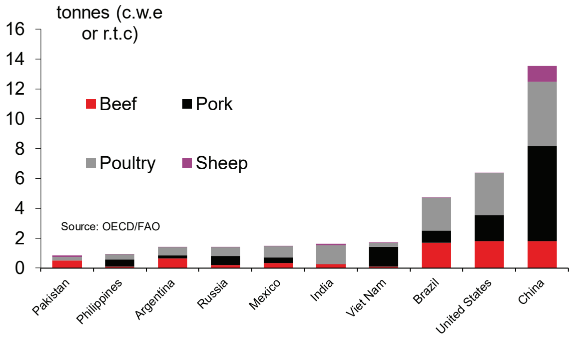
[1] https://www.fitchsolutions.com/country-risk-sovereigns/chinas-sectors-still-resilient-2019-outlook-most-despite-elevated-headwinds-25-03-2019?%E2%80%A6

also been indications of a greater acceptance of a role for international markets to complement local supply as well as increasing environmental regulations.

If successful, these policies are likely to lead to an increase in domestic production over time, potentially reducing demand for imports. However, even if ultimately successful, there will be challenges along the way. Attempts to industrialise milk production for example, have reportedly led to disruption to domestic production the short term, further increasing demand for imported dairy products.

China will also still face environmental constraints with access to water a key consideration. Milk production is concentrated in north western regions, with other parts of the country not as well suited for large scale agricultural production.

Countries with the greatest share of additional meat production 2027 vs 2015-17



Risks and opportunities

The increasing dominance of China as the primary destination for New Zealand's agricultural exports brings both opportunities and risks. Clearly, the growth in New Zealand exports to China shows Chinese consumers appetite and willingness to pay for New Zealand exports. What's more, in some cases increased demand from China is effectively raising the global price, forcing other countries to pay up in order to secure product. Demand from China has also provided a much stronger market for some traditionally lower value products. Prices have been trending higher for lamb flaps for example, which are used in the popular hot pot style of eating.

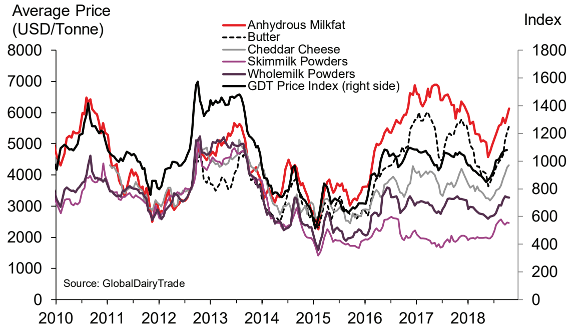
But with all roads now leading to China for New Zealand's agricultural exporters, any cooling in demand from China will have a significant impact. What's more, as China increasingly pursues trading relationships with a wider range of countries, the advantages offered by New Zealand's FTA with China will be eroded and competition to supply Chinese consumers will increase. Changes in consumers' tastes and preferences can also be fickle and difficult to foresee. What's hot now might not be nearly as popular in five years' time. New Zealand exporters will need to stay well attuned to the changing desires of their Chinese customers, which will be a complex and challenging task.

Anne Boniface
Senior Economist

Beyond the farm gate

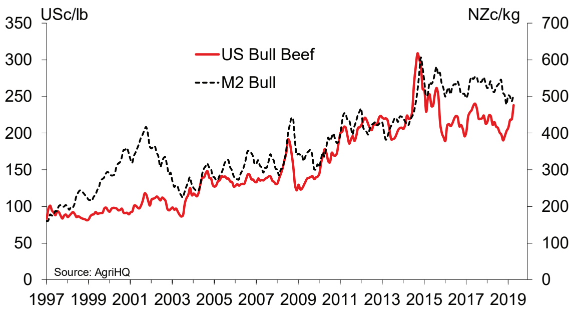
Dairy

Dairy prices edged a little higher in recent GlobalDairyTrade auctions. This has largely been on the back of renewed strength in fats prices. In contrast, whole milk powder prices have eased a touch in recent weeks as some of the concerns about the impact of earlier dry weather on NZ milk production have been tempered. NZ milk production fell 7.5% in March but with around 88% of milk for the 2018/19 now in the tin, we still expect milk collections for the season to be more than 2% higher than last year. Growth in milk production next season, however, won't be as strong. We see modest upside risk to our $6.40 milk price forecast for the current season. It also now looks likely that the 2019/20 season will start on a firmer footing, suggesting there is some upside risk to our current $7 farm gate milk price for this period.



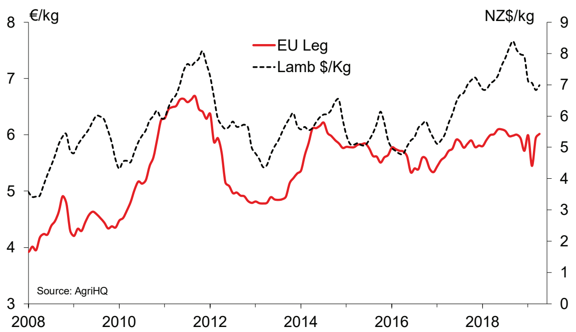
Beef

International beef prices have improved lately on the back of strong demand from China. There is increasing concern about the potential impact of the current African Swine Fever (ASF) outbreak in China and neighbouring countries. Some estimates suggest Chinese pork production could be cut by as much as 30% as pigs are culled in attempts to stop the spread of the disease in the world's largest pork exporter. While this will clearly increase demand for imported pork, at the margin it is likely to also boost demand for other meat including New Zealand beef (and sheepmeat) as consumers opt for pork substitutes.



Lamb

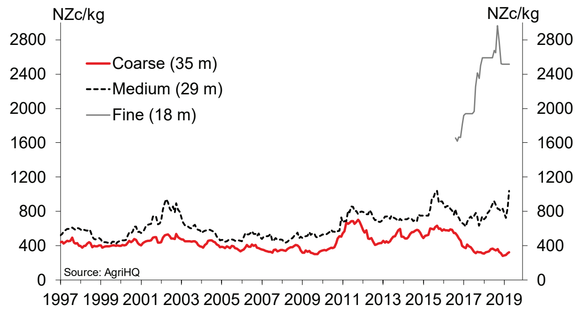
While there has been a seasonal decline in local lamb prices on the back of the usual lift in supply, international lamb prices remain well supported. Strong Chinese demand for both lamb and mutton has been a feature of the market. And with the potential for ASF (as discussed above) to further underpin Chinese demand this year and only modest growth in global supply expected, the outlook for lamb prices is relatively positive.



Beyond the farm gate

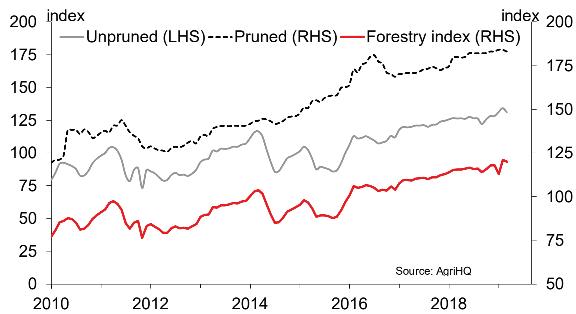
Wool

Strong wool prices have risen modestly off a low base in recent months. New Zealand wool prices may have benefitted from China's decision to suspend wool imports from South Africa following an outbreak of foot and mouth disease. In addition, the recent sharp rise in oil prices may also support a modestly stronger outlook for wool prices by pushing up the cost of synthetic wool substitutes. That said, we ultimately expect the recent lift in oil prices will prove temporary as higher prices encourage higher cost oil producers to increase supply.



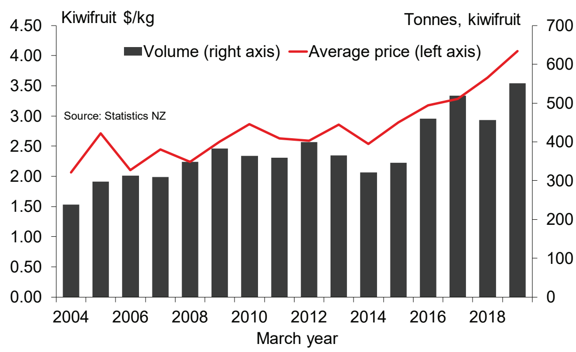
Forestry

Log prices have held up better than we expected over the last year on the back of continued strength in Chinese demand despite a slowdown in construction activity. However, export log prices fell relatively sharply in April, with reports of higher inventories in China weighing on prices. Locally, demand for timber remains firm with annual residential consent issuance at a multi-decade high. However, looking ahead we don't expect this pace of growth in local building activity to be maintained beyond this year, which could see local demand soften.



Horticulture

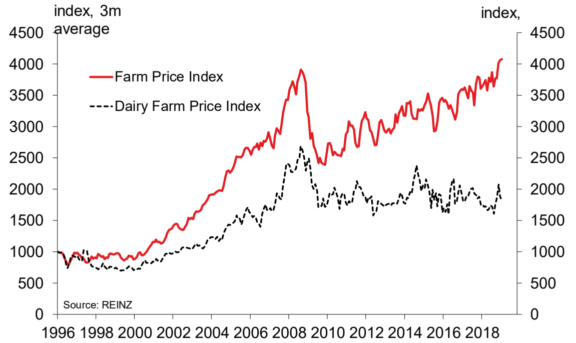
It's a busy time of year for many orchardists with kiwifruit and apple harvests in many parts of the country in full swing. Labour shortages remain a top concern for the industry with seasonal labour shortages declared in the Hawke's Bay and Bay of Plenty allowing growers to employ overseas workers for a period. Demand looks to remain firm in China and Japan, but for some products (such as gold kiwifruit) we expect growth in supply to weigh on prices. Zespri is expecting to export around 15% more gold fruit this season than last.



Beyond the farm gate

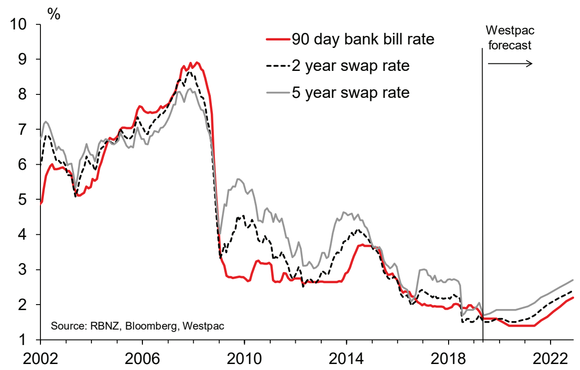
Farm prices

Farm sales volumes remained weak in March. The Government's announcement that it wouldn't be pushing ahead with any form of capital gains tax caught us by surprise but is likely to be well received by many in the rural sector. This, combined with the recent drop in wholesale interest rates and buoyant dairy prices could see some improvement in sentiment. However, it doesn't completely eliminate the concerns around increased costs associated with environmental and compliance issues concerning many farmers, particularly in the dairy sector.



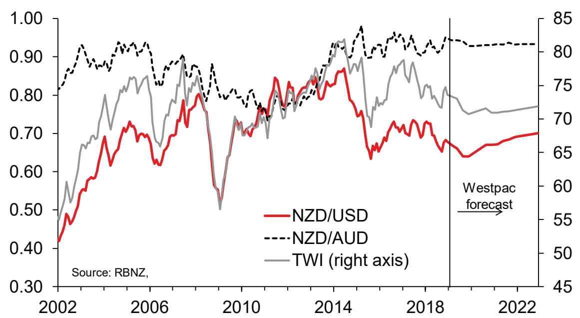
Interest rates

The RBNZ unexpectedly opened the door to a possibility of a cut in the OCR in its March OCR Review causing interest rates to fall sharply. On the back of this change in tone, and with the RBNZ concerned about the global growth outlook and inflation continuing to linger below 2%, we think the new RBNZ Monetary Policy committee will conclude that a lower OCR is appropriate at the May Monetary Policy Statement. However, this is a close call. Even if the RBNZ chooses not to cut the OCR it will likely leave the door open to OCR cuts in the future.



Exchange rate

The dovish shift from the RBNZ caused the New Zealand dollar to fall sharply in late March. And with the RBNZ expected to cut the OCR in May and leave open the possibility of further rate cuts from there, we think the NZ dollar will come under further downward pressure over the coming months. We're forecasting the NZD/USD to fall to 65 cents by the end of June (from a little above 66 cents currently) while the NZD/AUD is forecast to fall to 93 cents.



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