DISCUSSION NOTE

FROM	Michael Reddell
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SUBJECT	**WHAT ARE THE RISKS TO NEW ZEALAND FROM A SHARP/SUSTAINED SLOWING IN CHINA'S GROWTH?**

In some recent discussion (both internal and external - for example, the recent IMF Article IV) around New Zealand's economic situation there has been considerable focus on China, and the risks that a sharp or sustained slowing in China's growth rate could pose for New Zealand. That appears to have been brought into focus by the combination of several factors, including:

- The recent, probably temporary, emergence of China as the largest market for New Zealand merchandise exports.
- The rapid increase in dairy exports, in particular, to China.
- The high terms of trade, and
- The recent upsurge in unease about the risks of a sustained slowdown in China.

In this note, I will argue that a sharp or sustained Chinese slowdown poses real and substantial risks to New Zealand, but that the nature of those risks is rather different than much of the recent discussion suggests. To anticipate, China matters mostly because it generates around 15 per cent of global GDP in a world with few other "growth engines", not because it happens to be importing lots of New Zealand milk powder at present.

My focus here is on "if" a sharp Chinese slowdown occurs, not "whether" it does. But such a slowing, in one form or another, seems quite plausible: after a decade or more of export-led growth prior to the global recession, China has had half a decade of growth fuelled mainly by rampant domestic credit in a financial system with few market disciplines and pervasive moral hazard. With a hugely distorted economy and financial system, and signs that the government recognises the problems, it is far from clear where continued relatively rapid growth could come from at present. Global demand is relatively weak, the real exchange rate has risen very sharply, and domestic credit and investment demand also look to have run their course. And pretty much every emerging economy, having experienced a huge credit boom, has undergone some pretty difficult adjustments, or crises at one point or another. That doesn't detract from what is real or sustainable in the Chinese growth transformation - after all, almost all the previous emerging market crisis countries are richer and more prosperous today than they were when their respective crises hit. A substantial Chinese slowdown - even a recession (whether or not it was ever reported as such) seems quite plausible. If it doesn't happen the discussion in this note might be largely moot, but it is still worth thinking about the issue just in case.

And this note is also about the present. Dairy optimists talk in terms of huge long-term potential in China, as water-scarcity and changing food tastes substantially lifting per capita milk consumption and imports over time. Perhaps (tho the scepticism in the recent ABARES report is worth noting) but my interest here is what happens if China slows sharply in the next year or two.

Possible direct effects

Dairy tends to be the focus of attention at present, although China is a significant market for other primary products. China is the largest single export market for New Zealand dairy products at present, and currently the largest global importer of dairy products generally. The importance of different countries as destinations for New Zealand dairy exports fluctuates: in the last 15 years alone, Malaysia, Japan, Belgium, the United States, and Venezuela have each had a year (or more) as the largest single destination. The scale of current Chinese imports swamps those previous peaks - currently taking in excess of 30 per cent of total dairy exports, compared to earlier peaks of around 7 per cent. China's increased demand for milk imports in the last few years appears to have resulted substantially from the blow to China's own industry through the melamine scandal - production and productivity previously having been growing rapidly. New Zealand's place in the market has been helped by the free trade agreement, and in particular the provision of early tariff-free entry for infant milk powder.

Nonetheless, it is worth keeping the China trade in some perspective. First, despite having perhaps 20 per cent of world population, and 15 per cent of GDP, China accounts for around 5-6 per cent of global dairy consumption (most of which is produced locally). That makes overall Chinese dairy demand about half as important as demand/consumption from Latin America. By contrast, China has accounted for almost half of global steel consumption and production in the last couple of years. Chinese imports of iron ore make up over a third of global use of iron ore.

It is also worth keeping in perspective the nature of dairy products. The largest chunk of New Zealand dairy exports is milk powder, a fairly homogeneous product consumed widely across the globe. Thus it is neither a global product for which China is the dominant consumer (think iron ore) nor a specialised product developed and tailored specifically for the needs/tastes of a specific market, or where production has been ramped up specifically to meet demand from that particular market (in a way that perhaps some specialised manufactured products might have been). It is also not a product which New Zealand is a dominant producer of (around 2-3 per cent of total world milk production, and less than 10 per cent of on-market production).

The best approach to thinking about New Zealand's primary exports has long been that (a) whatever volume of milk is produced by farmers will be sold, and (b) pricing largely occurs in a global market, reflecting global supply and demand for the product in question. Global pricing transparency in dairy has improved considerably in recent years, and the role of eg European and US subsidies has diminished considerably. Of course, long-term protective barriers are still a real issue in several major markets, including India and China.
The global approach to thinking about prices for New Zealand export commodities has long served us well. The Great Depression saw the steepest fall in New Zealand's export prices and terms of trade on record (almost 40 per cent). The United Kingdom was overwhelmingly important as a destination market, taking around 70 per cent of total NZ exports on the eve of the Depression. The UK's own experience of the Great Depression was fairly moderate (much less severe than, say, the US or Germany) but that seems to have done very little to alleviate the extent of the fall in the terms of trade (when compared, say, with other commodity producers). Changes in global supply and demand conditions seem to have been what mattered. Much the same could no doubt be said for other big falls in real export prices (and the terms of trade), in for example 1952, 1958, 1967/68 and 1974/75.

Our own research illustrates how sensitive global dairy prices can be to changes in supply conditions. An *Analytical Note* (2013/02) last year produced estimates under which a New Zealand drought of the severity of that in early 2013, which lowers **New Zealand** production towards the end of the season by around 10 per cent, would raise **global** dairy prices by 10 per cent. And the experience of the New Zealand industry over the last decade, when higher real dairy prices prompted both a lot of land conversion to dairy, and much more feedintensive production processes, illustrates how responsive dairy supply can be to changes in dairy prices and the relative performance of dairy and input prices. Changes, perhaps quite small, in supply conditions in the US and the EU - much the largest market producers - have the potential to have a large impact on global dairy prices.

A significant Chinese economic slowdown could dampen global milk demand - though recall that Chinese growth has already slowed materially in the last few years. Rising unemployment or weaker-than-expected wage growth could be expected to adversely affect demand for what is, for most, a luxury and discretionary product. But even a 20 per cent reduction in total Chinese demand - a high degree of responsiveness - represents only around a 1 per cent drop in global demand. The sensitivity of dairy prices to quite small changes in the global supply/demand balance means that such a slowing in Chinese demand could result in quite marked changes in dairy prices. And, of course, whole milk powder prices have already fallen by around 20 per cent in the last couple of months. Whatever the cause of that specific fall it is a reminder of something well-known to most in the industry - dairy product prices are volatile, especially as advanced country price support schemes have receded in importance.

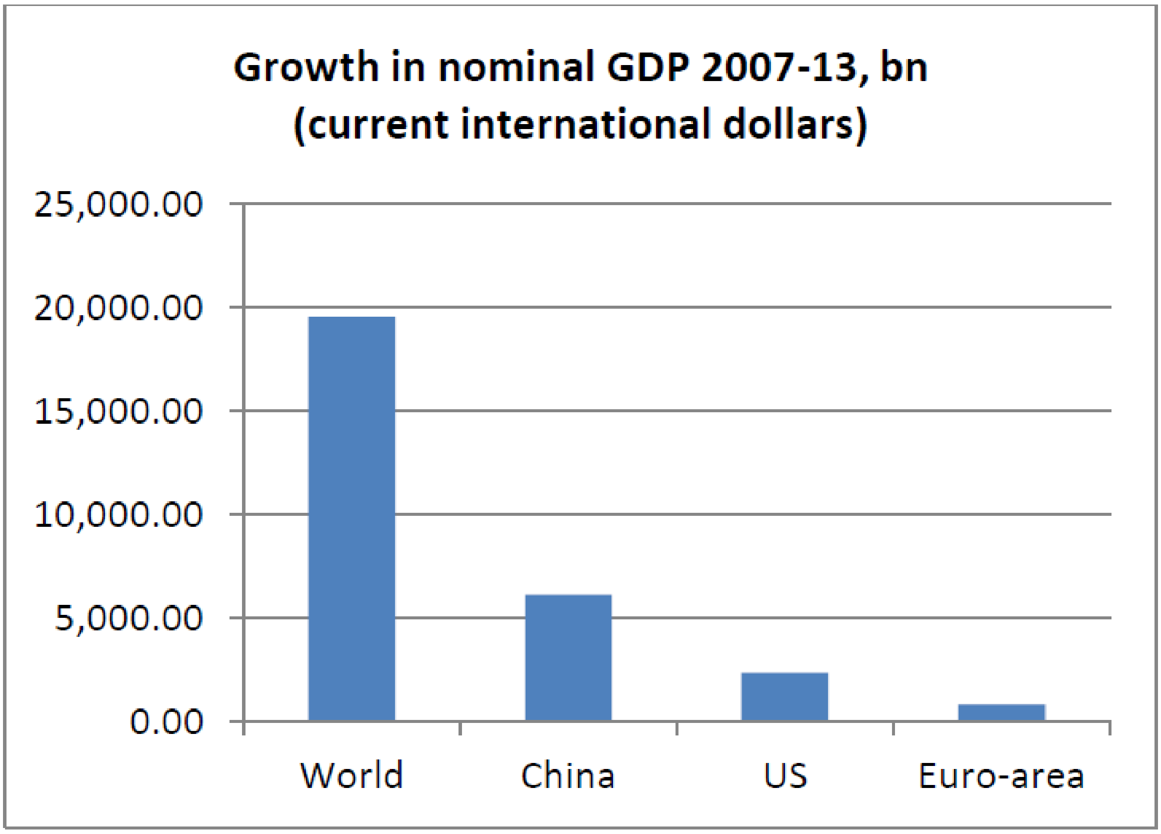
But a 1 per cent fall in global demand for milk sourced from China, important as it may be, is just one of the risks New Zealand dairy producers - and the New Zealand economy - face. TFP growth in dairy, even in technologically-advanced economies, has averaged around 2 per cent per annum: any changes in that must markedly affect production and price prospects. Chinese dairy interests, encouraged by the state, are putting considerable effort into lifting China’s own dairy production, and between artificially-low costs of capital, and the large number of very small herds, the prospects for large changes in China’s own production must be quite real, even in the relatively short-term. Globally, any decline in oil/gas prices will tend to lower feed prices, altering the supply conditions for the grain-fed diary industry abroad, while high dairy product prices themselves prompt additional supply. And climatic conditions in major production markets can go either way - those in NZ are self-stabilising from an income perspective, but those abroad flow quickly through into New Zealand’s terms of trade.

I’m not claiming expertise in any of these individual items, just suggesting that each warrant as much attention in thinking about NZ national income prospects - and indeed, financial stability risks around the farm sector - as the direct effects of a fall in China’s demand for dairy products.

It has also been noted that a severe Chinese slowdown, or domestic financial crisis, could increase the difficulty/cost New Zealand banks face in raising external wholesale funding. In isolation, the story is possible, but the risk of any sustained disruption is probably fairly small. Despite the increasing capital inflows in recent years, and the increased exposure of some European banks in particular to China, China’s financial system remains quite compartmentalised from the rest of the world. Of course, to the extent that markets impute “guilt by association” to Australasian banks then difficulties in China could create uncertainty and temporarily make buyers of bank bonds a little hesitant. But, if anything, that is an argument for making more of how limited New Zealand’s direct or idiosyncratic exposure to a Chinese slowdown is.

For example, there is a more plausible case that Australia’s economy might be more severely adversely affected by a severe Chinese slowdown - through significantly reduced demand for coal and iron ore (where China is a key market, and Australia a major global supplier). More new investment projects would presumably be shelved. However, even there it is worth highlighting that (a) many of the adverse income effects will fall on (majority) foreign-owners of the mining companies, and (b) that the Australian banking system is not heavily exposed to the mining companies themselves. Moreover, from a New Zealand perspective, and as we seeing at present, a deterioration in the domestic economy in Australia tends to alter, quite quickly, the net immigration flow between the two countries[1]. It is not clear that such a slowdown in Australia is, net, bad for domestic demand in New Zealand.

Indeed, a slowdown in China, giving rise to material job losses, might increase interest from Chinese in migrating to New Zealand. Since the migration programme is managed over a rolling three-year horizon, this could add some short-term upside demand effects.



But the point of this paper was not to suggest that we should be relaxed about a sharp slowing in China's growth, let alone a real Chinese recession.

China matters a great deal - but indirectly

As noted earlier, China now accounts for around 15 per cent of world GDP.
Since 2007, the pre-recession global peak, growth in China has accounted for just over 30 per cent of the growth in world GDP (using IMF WEO numbers). The contribution to world demand has been even greater than suggested by the GDP numbers, since over the same period China's current account surplus has shrunk very substantially (from around 10 per cent of GDP, to around 2 per cent). As noted earlier, the source of demand has been domestic, the policy-led domestic credit boom. That demand has had large implications for activity and demand (and commodity prices) in the rest of the world. China's large share of the growth in world demand isn't just an artefact of the 08/09 recession - from 2011 to 2013 China also accounted for 30 per cent of the growth in world GDP.

Given how important China has been to the global economy over the last few years, any sharp slowing in China's growth could be expected to have substantial effects on the world economy. There is likely to be quite a number of channels, but two would be prominent. First, orders by Chinese companies for goods (and services) produced elsewhere, whether capital, current, or intermediate, could be expected to be quite immediately affected, to minimise the risk of having to finance unwanted inventories in a climate of much tighter credit conditions. And second, companies in the rest of the world facing not just a disruption to the flow of orders, but considerable uncertainty about how deep or how long the trough would go, would be likely to suspend investment plans, and scale back their own orders. Uncertainty is a potent force in this sort of environment, the more so when the memory of 2008/09 is still quite recent, and when the country concerned is China - both large, and hard to read even for China experts. As the 2008/09 episode illustrated, interconnected global supply chains - and potential disruptions to trade finance - can mean very large and rapid reductions in world trade and in global activity. For now, markets still appear to have considerable belief in the willingness and ability (both matter) of the Chinese authorities to prevent a sharp slowdown: if they are proved wrong, the adjustment around the world could be particularly severe.

The potential for such a disruption to activity might be less severe if we were sitting at the start of 2008 again (when, by the way, the economy at the heart of the slowdown, the US, accounted for 21 per cent of world GDP). In 2008 almost every country had room for significant policy stimulus, to mitigate the domestic (and cumulative global effects) of one country’s crisis/recession. Interest rates were mostly at cyclical peaks, and with the exception of Japan the zero lower bound was not binding. In many/most countries, there was also considered to be significant fiscal space. Perhaps most all, there was China, relatively underleveraged going into the global recession, with the capacity to spark a globally significant domestic credit boom. Today there is no credible replacement China - either a large advanced economy with strong self-sustaining accelerating growth, or a major under-geared emerging economy willing to spark a credit boom with spillover benefits for world demand/activity.

Throughout the advanced world there is only a handful of countries with any material room to lower policy interest rates - and even those such as New Zealand or Australia have only around half a typical cycle’s worth (recall that we cut 575bps in 2008/09). The situation is different in major emerging countries, such as India, Brazil, or Turkey, but having exhausted their own credit booms over the last few years, and with their own growth rates slowing, they seem unlikely to be an adequate replacement for stimulus that might once had come from the US or Europe. Some put more weight on the potency of quantitative easing than I do, but I doubt anyone really believes that the remaining scope for such activity is anything like a full substitute for the usual scope to adjust policy interest rates.

The constraints are also very real around fiscal policy, not least that ageing population pressures are 6 years closer than they were in 2008. Again, some countries - think Sweden or Switzerland or Norway - might have room, and perhaps even a political willingness to act. In NZ and Australia, the Crown balance sheets look fine (although much less good than in 2007), but a sharp fall in global commodity prices would reveal pre-existing significant structural deficits, even before considering discretionary stimulus. But all of these countries together are still small. It is difficult to envisage that there is political room for material additional fiscal stimulus in the US, UK or Japan. And the elephant in the room, in any renewed significant global slowdown would be the euro. The crisis has been fairly quiescent over the last year or two, but as everyone recognises the fundamental stresses and tensions have not gone away. The likelihood of any major euro-area country feeling that it had both the political and market room to engage in discretionary fiscal stimulus on a substantial scale seems remote. (Germany might have market room, but would be unlikely to have domestic political room, especially now that the population is falling and the debt burden rising.) It would be a major challenge for the European authorities to stop a renewed crisis once again threatening the very existence of the currency. Financial markets, firms, and individuals would all quickly recognise that.

China itself has one important option, even if it chose not to engage in large-scale fiscal or quasi-fiscal (credit stimulus). It could allow the exchange rate to fall, and to fall substantially. Doing so would assist in rebalancing the Chinese economy, back towards the tradables sector. Global demand conditions might still be very weak, but it would enable Chinese producers to get a hard start on capturing a significant chunk of that demand. Given the excess capacity in some key Chinese industries - and the likely increase in that excess capacity if China were to slow sharply - such a depreciation in the yuan would be likely to represent a significant direct deflationary shock.

Faced with these sorts of constraints and threats - the absence of a replacement engine for world growth, constrained by the technology/legislation that makes the ZLB matter - New Zealand really would be quite exposed:

- Global demand for high-end food products (dairy and lamb) would be adversely affected, and commodity prices would fall steeply. The exchange rate would, no doubt, fall, but the income hit would be real and substantial nonetheless.
- Other parts of the tradables sector would also be hit - manufacturing, tourism, export education.
- Renewed threats to the global banking system, in Europe in particular, and uncertainty about the global climate, could well increase the cost and disrupt confidence in access to foreign wholesale funding. Since activity would weaken substantially here too, and the exchange rate would be lower, the foreign currency value of the amount of funding banks might need to raise would be very low.
- The risk of global deflation would increase markedly. Since debt is almost entirely nominal, unexpected deflation remains – as in the 1930s - a substantial risk, for both government and private borrowers.
- While NZ has more monetary policy space than most advanced economies, and once the interest rate differential disappeared, the exchange rate could be expected to be very weak, it is not clear that we would be totally immune to the deflationary risks (at very least we might struggle to get inflation consistently as high as the target midpoint).

None of this is to suggest that NZ is more exposed than most. If anything, we are probably less exposed than most to problems in China. Our exposure is highest if a sharp or sustained Chinese slowing were to have severe implications for the wider world economy – if, that is, no replacement "growth engine" appeared. Problems/recessions don't last forever, but they don't need to do so to prove very troublesome - and the world has fewer easy options if things go wrong now than it did in 2008, or in 1930[1]. Risks of a reversion to protectionism, largely averted over 2008/09, would loom large again, as one way to stimulate domestic demand at least in the short-term.

The spectre of global deflation - while not a central view by any means - reminds us that probably the greatest single threat to the ability of our banking system to repay its creditors would be events that gave rise to a period of sustained deflation, in which the burden of the dairy debt (in particular) simply led large borrowers to walk away. Rural debt was the biggest financial issue New Zealand faced in the Great Depression - then, the financial system was perhaps fortunate that little of the substantial rural debt was provided through the intermediated sector.

Conclusion

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[1] Something of a perennial point of mine. See, for example, my 2010 Treasury discussion note "How, in some respects, the world looks as vulnerable as it was in 1929/30".

Whatever one’s view about the probability of a sharp slowing in China’s economy, if it were to happen over the next year or two it would represent a very substantial threat to the health of the world economy, at a time when it has few countervailing tools at its disposal, no coordinating devices, and little recuperative power given the existing debt overhang in much of the world, slowing population growth etc. The threat to the world economy, and its financial system, seems more likely to pose significant economic and financial threats to New Zealand than any direct impact from China to New Zealand. Those latter effects seem likely to be no larger than the normal swings and roundabouts a modern economy faces from year to year.