

# CHINA AND NEW ZEALAND UPDATE

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*It is no disgrace to have many afflictions;  
I would worry if there never were any afflictions.*

Huanchu Daoren

## New Zealand's China factor

The current weakness and volatility of global markets will continue to cause considerable damage to the marginally solvent economies of Europe and the United States. Under present circumstances, the economic impact on China will be slight. This is good for New Zealand to the extent that its trade with China will likely increase substantially as China continues to diversify away from its trading relationship with the United States. The New Zealand economy is not all about China, but it is largely so. Much of New Zealand's trade with its biggest trading partner, Australia, is a proxy for its second-largest partner, China.

Despite forecasts to the contrary over the last decade, China has managed the development of its agricultural sector well. Farmland has increased by about 10% and China remains largely independent in agricultural products, with the exception of soybeans, timber, whole milk powder and wool. New Zealand's strengths match China's needs. Given this strong trading position, the New Zealand Government's prudent management of the national debt, the improved state of company balance sheets since 2008, and ongoing stimulus in the form of Christchurch's reconstruction and the Rugby World Cup, government assurances this week that the economy is in reasonable shape are more than pre-election posturing; they reflect present economic reality.

Value is still too much defined by global capital markets, which become cockpits of fear and greed whenever there is uncertainty. It is a pity that economies are still held hostage to the very rating agencies that failed in their oversight and let the subprime travesties stomp by them. New Zealand is vulnerable to the excitable vacillation of global capital markets, but need not give in to the extremes of fear and greed that they trigger. The relative calm and confidence with which the New Zealand Government has dealt with the current global market crisis is both realistic and admirable, and will not be lost on its Asian, and particularly Chinese, trading partners.

Should US treasuries reverse the current illogical gains, China may lose 10 to 15% of the US dollar value of its foreign exchange reserves in the coming months. Yet with reserves of over US\$3 trillion, such losses would be sustainable. US treasuries comprise 65% of China's foreign exchange reserves and Eurobonds a further 15%. Fortunately, China cannot sell these assets

without damaging the value of its own holdings. China is also no longer in a position to intervene in either the European or US economy by buying more paper. With the inclusion of Italy in the group of now vulnerable European economies, China would not make a material difference by suddenly increasing its Eurobond holdings.

Some New Zealand businesses and policy makers are concerned with the rise in Chinese inflation in the third quarter. Although it is probable that China will fail in its aim to keep annual inflation at 5% (it is now more likely to reach 5.7% or even 6%), this is not, however, a major macroeconomic issue. Such rates are tolerable in an economy that is still enjoying strong, well grounded economic growth. A weaker US dollar will increase the price of Chinese exports, but not to the extent that China will face a trade deficit this year. China's trade account, while important, is not as critical as the internal economic drivers of domestic investment and consumption. Further general tightening of credit in China is also unlikely; on the contrary, credit to small and medium-sized enterprises is likely to be increased. As much as the Chinese Government fears inflation, it knows that growth is an equally sensitive issue. Much of the inflation in the price of food is due to structural supply-chain issues rather than chronic distortions, and inflation in property is largely the result of overwhelming demand and some speculative state-owned enterprise investment. Even recent moves to curtail inflation in the high-end property market through credit restrictions are being offset by increases in the construction of affordable housing.

Under present global economic conditions, China is unlikely to stimulate its own economy. Having done so in 2009 and 2010, the Chinese Government has come to realise that it is not as vulnerable to the world economy as it feared, due to its closed capital markets, non-convertible currency and robust domestic economy. Although the last two stimulus initiatives were bold and decisive in a global crisis when others were acting out of fear and uncertainty, these initiatives also contributed to the higher inflation facing China today. Chinese policies are likely to balance inflation and growth in the coming months but without the over-steering of past years. Recent international events nevertheless present China with two challenges: imported inflation and possible long-term attrition of exports.

While New Zealand may justifiably take comfort in the extent to which its key industries are exposed to China's positive growth story, it cannot allow complacency to hinder wider thinking and innovation. More value-added products must be created for not just China but all markets. New Zealand could enjoy much greater profits from its dairy industry if companies developed products such as infant formulas and yogurt brands. New Zealand aquaculture enters the Chinese market largely unbranded, and considerable value is lost every time New Zealand ships unprocessed trees to its trading partners. New Zealand must also be careful not to tolerate xenophobic barriers to Chinese investment, lest it face retaliation in China.

New Zealand has yet to brand itself in China, building on the strengths of sustainability, food safety and commercial transparency. It is not too late to do all these things. ☺