9 August 2013

Concentration Risk

- One miniscule spore, one huge headache
- Fonterra whey scandal now market history
- But highlights New Zealand's increasing dependence on a single product
- And a single market
- Economic resilience at threat

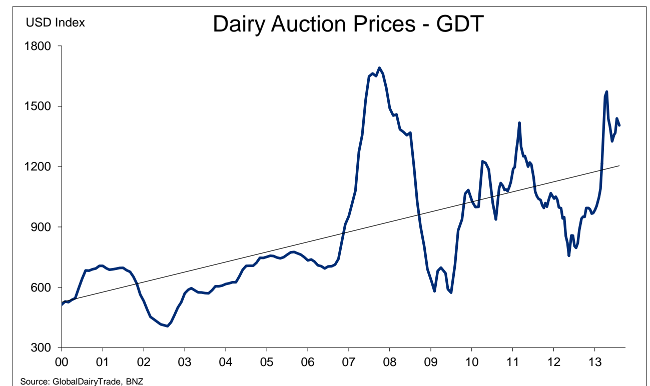
It is a little bit scary to wonder what kind of nation we live in when a single, small, dirty pipe threatens to bring the nation to its knees. That indeed was the fear when, over the weekend, Fonterra announced the contamination of a small amount of whey powder from a Waikato processing plant.

As it is evolving, for all but Fonterra's reputation, this incident is proving to be a bit of a storm in a teacup and, as we had suggested, the knee jerk reaction by financial markets was unwarranted and has, since, largely been unwound. In particular: the New Zealand Dollar is back above the level immediately pre the Fonterra announcement; the Fonterra Shareholder Fund share price has climbed back to $6.95 from a $6.50 low; and the GDT price auction went off without a hitch with prices falling only 2.4% to be up 71.5% on year earlier levels.

Be that as it may, what the events of the last few days have done is highlight the concentration risk that New Zealand faces as a nation. Moreover, this concentration risk is getting stronger by the day. Policy makers need to pay more attention to this and New Zealanders, in general, need to be more aware of the risks.

This concentration risk largely revolves around our export mix and the destinations to which we export. However, the argument for excess concentration might also be applied to regional development. While there is a strong body of literature saying that larger cities are more efficient it must also be true that economic dependence on a single city must also bring with it increased vulnerability. The vulnerability of places like Wellington and Christchurch are readily apparent but Auckland is not immune to regional disaster.

Excess concentration on a single market or product typically leads to increased export revenue volatility which in turn is strongly linked to growth volatility. So not only is the economy more vulnerable but also, typically, it records lower growth than a more diverse economy.

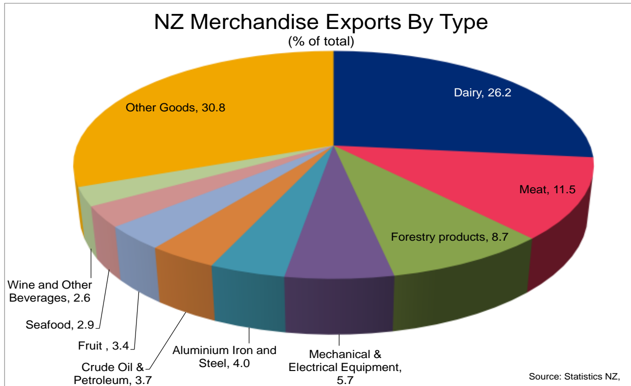


It's not as if we haven't been there before. In the 1950s New Zealand was a highly successful country exporting frozen lamb carcasses, wool and butter to the UK. And, then in the late 1960s wool prices collapsed and threw the economy into recession. Wool as a share of New Zealand's merchandise exports fell from 30% in 1966 to 19% in 1968. In the 1970s along came the EEC and the wheels well and truly fell off leading to a long and painful adjustment for the New Zealand economy. We've spent much of this century developing a much more diversified economy but, more recently, things have again been going the other way.

We are not anti-Chinese and we are not anti-dairy but the last thing New Zealand wants to become is nothing more than a milk powder exporter to China. Economic diversification is as important as investment diversification from a risk profile perspective. The answer is not to kill off existing trading relationships or reduce dairy production but to look to other sectors to play a bigger part.

You don't want to be hostage to a single product just in case something goes wrong with either the demand for, or supply of, that product. Contamination is an obvious supply threat for New Zealand dairy. But, for any product, there is always the risk of a change in taste or the introduction of a substitute. Just think what happened to Kodak when camera film became redundant. Admittedly the chances of redundancy are much less in food products but the potential supply shocks are much greater.

And, you certainly don't want to be hostage to a single purchaser anywhere in the supply chain. An economic slump can drive demand lower or, if the purchaser becomes too dominant, they might work themselves



into such a position of power that they can take monopsony control of the sale price.

We're not exactly pushing the panic button on matters China and dairy, especially as dairy has been even more dominant in the past, but a recap of the situation is probably warranted.

The dairy sector accounts for 26% of New Zealand's merchandise exports. Dairy is New Zealand's single biggest export group by a significant margin. Meat comes in a distant second at 12%. Importantly there are a number of shocks that might impact both export groups at the same time – drought being the obvious one and stock disease such as foot and mouth being another.

There's no official measure of optimal diversification but it goes without saying that if almost 40% of your export base is at threat from a single shock your economy is inherently vulnerable.

China does not yet dominate our total export profile. It is our second largest export destination taking 17% of our goods exports. It's way above number three, the United States, at 9% and is fast closing in on Australia, which takes 21%.

But it is the pace of that growth which is simply staggering. It's difficult to believe but as recently as mid-1990, China took less than 1.0% of our exports. In 2000 it was still less than 3.0%. The share moved above 10% in 2010 and has moved progressively higher since.

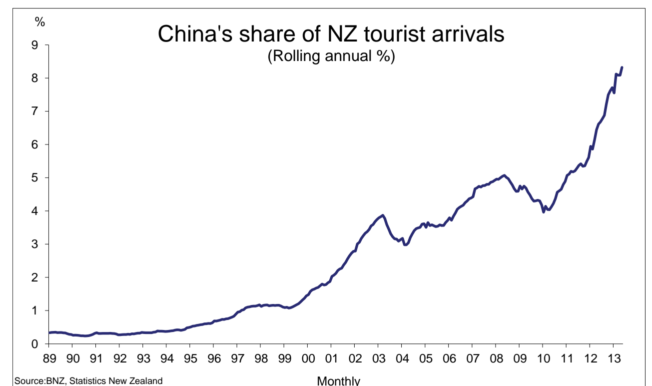
Another way of looking at this is that exports to China grew 26.5% in the June year 2013 at the same time that exports to the rest of the world contracted 6.5%.

As an aside, so strong has been the growth in New Zealand exports that New Zealand will soon be running a trade surplus with China. This may come as a surprise to those who continue to bemoan the penetration of the domestic market by Chinese produced goods.

Around three quarters of the growth over the last five years can be attributed to the expansion in dairy exports – highlighting recent concerns – while the rest is dominated by forest products. Be this as it may, it is interesting to note that the wool and hides, skins and leather industries are still the most vulnerable sectors to Chinese demand.

It's worth noting that New Zealand is not only benefitting from its export of goods but services exports to China are also on the rise. The most obvious of these is tourism. The importance of tourism to the economy should not be underestimated. Travel receipts actually exceed meat sales. China has gone from providing almost no tourists to New Zealand to now accounting for over 8.0% of inflows. In the month of January 1990 72 Chinese tourists arrived in NZ. You could just about have named them all. In January 2013, there were almost 19,000 arrivals.

Those keen to stop the Chinese flow of capital into New Zealand should recognize that they can't hope for the Chinese to remain such strong drivers of our economic expansion at the same time.



New Zealand can be very thankful to the people of China, and elsewhere in developing Asia for that matter, for keeping our economy afloat. In the same vein, we can also be very thankful that we have had an agriculture based economy that has produced the right goods at the right time for the right part of the world.

In our opinion, New Zealand's future will remain dominated by its increasing integration with Asia and the comparative advantage we have in producing agriculture output. This is to be celebrated. However, we need to be very wary that we are creating a concentration risk that leaves us extraordinarily vulnerable to a single product and a single market. The sustainability of our prosperity may be highly dependent on ensuring that this this does not get out of hand.

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