

Expected Trends in the New Zealand-China Dairy Trade

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<https://www.e-ir.info/2013/10/29/expected-trends-in-the-new-zealand-china-dairy-trade/>

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Playing Into Their Hands: Expected Trends in the New Zealand-China Dairy Trade

In response to the recent Fonterra botulism scare, the *New Zealand Herald* published the following comment: "They'll be loving it because it just plays into their hands doesn't it? Here they are trying to protect the Chinese infant formula industry and limit New Zealand and this just couldn't have played out better for them." [1] This quote stems from a common assumption held by some New Zealanders: that the New Zealand dairy industry, thanks to the 2008 Free Trade Agreement, poses a threat to China's domestic industry and that it would therefore be in China's best interests to limit dairy trade with New Zealand.

Until the botulism scare, New Zealand's dairy trade with China has shown little sign of slowing. [2] When predicting trends in bilateral trade that show no market-led signs of slowing growth, we can expect to see one of three broad trends: decreasing growth limited by the exporter; decreasing growth limited by the importer; or continued growth with neither party seeking limitations. The *New Zealand Herald* assumes that it would be in China's best interests to limit growth of New Zealand dairy imports, and so might expect the second possible trend. However a closer look at China's domestic agricultural capabilities, as well as other benefits to both countries, reaffirms that it is in neither country's interest to limit growth and suggests that the China-NZ dairy trade will continue to grow in the near future.

New Zealand's interests in the continued growth of the dairy trade are clear. China is the destination for 15.2% of New Zealand's exports—over half of which are dairy products—and the Treasury estimates that merchandise exports to China made up 3.3% of New Zealand's GDP in 2012. [3] The dairy and forestry industries have together contributed 2.1 percentage points to New Zealand's 4.1% real GDP growth over the last four years, largely thanks to increased Chinese demand for "pure" New Zealand products after the 2008 melamine scare. [4] The Treasury maintains that this increase in demand for dairy exports has not been met by trade diversion from other markets, but rather by increased production efficiency. [5]

These combined economic benefits have been a driving force behind the New Zealand Ministry of Foreign Affairs and Trade (MFAT)'s 2015 China Strategy. [6] Among the goals of the strategy are doubling the value of two-way goods trade to \$20 billion, growing the services trade by up to 60% in some sectors and increasing bilateral FDI. Clearly the New Zealand government sees the benefits of increasing trade with China, and is not seeking to limit growth in any way.

Continued trade with New Zealand, particularly in dairy, is also appealing to China. One of the main reasons for this is because of China's own agricultural limitations. Historically, China has been an agrarian culture, producing cereals like grain in the north and rice in the south. However due to a combination of difficult terrain limiting industrialisation, devastating agricultural management during the Mao era and an ever-growing population, China remains unable to feed its own population. [7] Food security remains a priority for the Chinese government as large quantities of grains and other agricultural products must be imported from overseas producers, including New Zealand and Australia. [8] A rising middle class and increasing urbanisation of diet are also contributing to an increasing demand for dairy products that again outstrips domestic supply. [9]

New Zealand supplies dairy to meet this increased demand and acts as a source of "technology and know-how" that

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can increase China's domestic production.[10] Fonterra, New Zealand's primary dairy exporter, currently operates a subsidiary called China Farms that is the "key enabler of the China growth strategy," investing in Chinese producers and using international technology to maximise local output.[11] With New Zealand producers like Fonterra making up the shortfall, it is no surprise that China's medium-term plan for national food security encourages Chinese firms to go abroad and "establish long-term and stable agricultural industry cooperation relationships with... important agriculture producing nations." [12] As long as New Zealand is contributing to China's food security, it appears that the Chinese government will want to maintain good relations.

But what happens when China becomes agriculturally self-sufficient? Will it still find trading with New Zealand to be of use, or will New Zealand producers be seen as a threat to local industry that needs to be limited? Zhao et al. predict that by 2030, China will have increased agricultural efficiency to the point where it can feed itself, using a combination of grains and other agricultural products like dairy.[13] With this in mind we could perhaps imagine Chinese policymakers wanting to "ready the ground" for their domestic producers and limit competition from New Zealand dairy farms.

Thankfully, this does not appear to be the case. The 2030 figure is based purely on gross production of agricultural goods and relies on declining demand for grains, as the population urbanises and Westernises in diet, to free up more land for other agricultural products like dairy.[14] This does not account for the grain consumed by cattle, which will increase dramatically if the domestic dairy industry continues to grow. This means that in 2030 either feed or dairy product will still need to be imported from overseas, provided there are continued opportunities for New Zealand producers.

This also ignores a number of other factors that are not purely quantitative, and which will all provide incentive for China not to limit trade with New Zealand even as its domestic agricultural capabilities increase. We should not ignore the fact that bilateral FDI has strengthened economic ties between China and New Zealand to the point where we cannot talk about purely domestic and international producers. Fonterra's China Farms subsidiary produces dairy products within China, but using New Zealand capital and management. Likewise, Chinese firms are encouraged to invest in New Zealand, primarily to "secure supply of high quality food products in order to meet the growing demand for protein and to assist China's agricultural industry to learn from the New Zealand industry which has a reputation for quality." [15] These bilateral investments would make it difficult for either country to limit trade as the line between domestic and international producer becomes blurred.

New Zealand's reputation for quality also comes into play. Even while domestic producers increase their yield, the Chinese consumer still prefers New Zealand products because of their perceived higher quality and food safety standards.[16] This becomes very apparent when looking at the 2008 melamine scandal: Xinhua reported a considerable loss of faith in local dairy producers by consumers, dealing a severe blow to the industry.[17] The Chinese government was faced with allegations of covering up the story, while Fonterra (a significant minority shareholder in the Sanlu factory) and the New Zealand government were applauded for working together to bring the scandal to light and halt production.[18] This gave Chinese consumers an impression of the differing approaches of Chinese and New Zealand companies and government agencies, which has played a large part in the success of New Zealand dairy products in China. Demand for New Zealand dairy is subtly different from demand for Chinese dairy, and if China were to now limit importation and attempt to satisfy growing demand with local supply, many consumers would be unhappy.

On this note, we should also consider that not all dairy products are created equal. There is a significant difference in production method between pure homogenised milk, aged cheeses, and milk powder, to name but a few variants. Even if China were to increase its production of raw dairy, this would not necessarily replace refined dairy products from New Zealand. These value-added products are a growing source of revenue for New Zealand exporters and are expected to increase in export quantity over the next few years to diversify and intensify our revenue.[19] These are not products that China can easily replace with domestic alternatives.

We should also consider the international implications of any attempt by China to limit New Zealand trade. New Zealand was the first OECD country to sign a FTA with China, and as such serves as a model for what trade with

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China could be like for other, larger OECD countries. China is currently in various stages of negotiation on 16 other FTAs, and sees them as an important component of the policies of “opening up” and increasing domestic economic development.[20] If China wants these FTAs to be successful, it needs to show a continued mutual benefit to both parties in the China-New Zealand FTA; limiting the dairy trade, no matter the short term benefits to China, could ultimately sour some of the proposed deals with major economies that China so desires.

These all provide barriers to China’s limitation of New Zealand dairy products, but would China truly want to limit these imports in the first place? The central assumption of the unnamed industry source in the *Herald* article is that although New Zealand’s dairy exports meet Chinese demand, they pose a serious threat to the growth of the Chinese economy. Ultimately this is not the case; while China may rely on New Zealand imports for food security, and is its largest export market, New Zealand’s overall economic significance to China is “in no way comparable,” accounting for 0.2857% of Chinese imports and a mere 0.004% of Chinese FDI. [21] New Zealand’s dairy products may be out-competing China’s, but this is happening on such a small scale relative to the size of the Chinese economy that the idea of New Zealand being a threat to China is laughable.

Given these factors, it seems unlikely that China has any desire to limit dairy trade with New Zealand in the near future. China’s agricultural production is still at a level far below its domestic demand, and food security remains a high priority for the government. China’s own dairy industry may be developing, but it is nowhere near the same level of production as New Zealand farms and factories, and Chinese consumers will not be easily satisfied by domestic goods in place of New Zealand’s, given our high quality and food safety standards. China and New Zealand’s close economic ties as a result of mutual FDI, China’s need to appear a desirable trading partner to other OECD countries, and the small scale of the impact that New Zealand has on China’s economic development all suggest that China will make no effort to limit the dairy trade, despite the assumptions of the *Herald*. Given the benefit of this trade to New Zealand it seems highly unlikely that any limitations will be imposed from our end, suggesting continued growth of this trade in the foreseeable future.

However it is undeniable that *Xinhua*, the voice of the Chinese state, played up the seriousness of the botulism scare. It has since been confirmed that no Fonterra products were actually contaminated and Fonterra is now being applauded by *Xinhua* for its prompt action in recalling products and placing food safety as its highest priority with a similar transparency to that which brought it praise during the 2008 melamine scandal.[22] Why then was *Xinhua* initially so hostile to Fonterra, calling it a “festering sore” (as quoted in the original *Herald* article)?[23]

We can imagine a number of explanations for this condemnation, which given China’s interest in positive long-term trade relations with New Zealand seem more plausible than the *Herald’s* thesis of protecting domestic industry in the face of competition from Fonterra. China may have wanted to apply some pressure to New Zealand in the wake of our recent Economic Cooperation Agreement with “Chinese Taipei,” a strengthening of our independent relationship with an economy considered by China to be akin to a rogue province.[24] Media hostility towards New Zealand over the botulism scare could have been a reminder by the Chinese government of the importance of our economic relationship with the mainland in response to the Taiwan agreement.

We could also consider this an assurance to the Chinese public of the state’s commitment to increased food safety standards, an assurance badly needed after the 2008 scandal and the state’s poor response. Policy-makers may have feared that a lax response to Fonterra’s announcement of potential contamination could be seen by the public as yet another example of China’s prioritisation of profit over safety, and so publicly condemned Fonterra as a means of proving otherwise.

Unfortunately, the long-term effects of both *Xinhua’s* condemnation and the *Herald’s* response could prove to be a threat in themselves to the future of economic relations. By disseminating this idea that New Zealand and Chinese dairy industries are in competition with one another, the *Herald* is encouraging an anti-Chinese sentiment in New Zealand’s consumers and producers. An economy does not consist solely of goods and trade, but of people who act on ideational as well as rational factors. If this distrust of China were to spread, and New Zealanders become too wary of “playing into China’s hands,” then the close economic relationship that has been built up over many years could begin to fall apart. As the China Research Centre’s report notes, “in today’s world economy, sustainable

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economic relations are built not only on trade relations but also through services, investment and people flows.”[25] New Zealanders will not invest in a country that they do not trust, and this lack of trust could prove highly detrimental to both parties in the long run. The media, as well as academia, have a large role to play in securing the future of China and New Zealand’s economic relations by promoting a positive personal, cultural and social relationship.

As long as we continue to promote positive trade relations with China, as MFAT is attempting to do with its 2015 China Strategy, we can expect to see mutual benefit for many years to come. China relies on New Zealand, among other agricultural nations, for its food security, and our dairy trade satisfies an increasing demand for high-quality, safe dairy products that will only increase as China’s middle classes continue to grow. Despite the allegations of the *Herald*, there is little cause for either nation to be dissatisfied with this continued growth and so no limitations are likely.

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[2] Scott Bowman and Patrick Conway, “China’s Recent Growth and its Impact on the New Zealand Economy,” *New Zealand Treasury Working Papers* 13:15 (2013), 18

[3] *Ibid*, 16, 27

[4] *Ibid*, 27

[5] *Ibid*, 18-19

[6] *Opening Doors to China: New Zealand’s 2015 Vision* (Wellington, New Zealand: NZTE and MFAT, 2012), 16

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- [7] Xiaoming Huang and Jason Young, *China and the World Economy: Challenges and Opportunities for New Zealand* (Wellington, New Zealand: China Contemporary Research Centre, 2013), 41
- [8] Ibid
- [9] Bowman and Conway, "China's Recent Growth," 18
- [10] Huang and Young, *China and the World Economy*, 51
- [11] "Progress: Interim Report 2013," Fonterra Co-operative (2013), 14
- [12] Huang and Young, *China and the World Economy*, 51
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- [22] "Precautionary Recall of Whey Protein Accomplished," *Xinhua*, September 7th, 2013
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- [24] Audrey Young, "Taiwan Agreement paves way for removal of all export tariffs," *New Zealand Herald*, July 11th, 2013
- [25] Huang and Young, *China and the World Economy*, 75

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Date written: September 2013