

## Fortnightly Agri Update

19 February 2014

**Chinese Demand for Dairy**

As we've noted in recent *Fortnightly Agri Updates* it is difficult, if not impossible, to talk about demand for New Zealand's commodity exports without highlighting China. And nowhere is the growing dominance of Chinese demand more apparent than in dairy markets. In this week's update we take a quick look at just two of the key structural changes in the Chinese economy which are driving demand for dairy.

New Zealand's dairy exports to China exploded in 2013. Over the year, the value of NZ's dairy exports to China grew 79%. This was in part due to a lift in prices and a bounce back in production following the drought, but the proportion of NZ's dairy exports destined for China has also been growing strongly. In 2013 34% of New Zealand's dairy exports (by value) headed for China, compared with just 22% in 2012 and 18% in 2011.

Although there are a myriad of important factors driving Chinese demand for dairy products, two of the key structural influences are income growth and urbanisation. These two factors have boosted Chinese demand for dairy significantly and in our view, will continue to do so for the next decade or more.

Chinese incomes have increased substantially over the last decade on the back of strong economic growth, with growth in incomes more rapid than in other emerging market economies. The OECD reports that by 2010, the number of people below the poverty line had fallen by 150 million compared to 10 years previously. In addition, inequality between rural and urban populations has fallen. But there is potentially a long way to go yet. In aggregate, Chinese incomes are still only a fraction of those in developed economies.

Income growth is often considered to be the one of the most important drivers of demand for dairy products. In China, the consumption of dairy products by residents in the top income quintile was more than double that for the bottom income quintile in both rural and urban areas.<sup>1</sup> Research suggests that the income elasticity of demand for dairy products is high relative to other food products, implying that for any given increase in income, demand for dairy products will grow more than for other types of food.

Although we expected GDP growth in China to slow from the breakneck pace of the last few years, an increasing proportion of household incomes may well be spent, as social safety nets gradually improve. There is also clearly a focus by the current Chinese leadership on rebalancing the Chinese economy, in attempt to improve the sustainability of growth. This is likely to mean that domestic consumption becomes relatively bigger share of the Chinese economy (currently consumption comprises just 35% of GDP compared to NZ where it is around 60%), at the expense of investment.

<sup>1</sup> Food Consumption Trends in China, Zhou, Z., Tian, W., Wang, J, Liu, H and L. Cao., April 2012

<sup>2</sup> The Outlook for China's Growth and its impact on NZ Exports, Bowman, S. and P. Conway, NZ Treasury, July 2013

However, even compared to countries of similar income levels, China's dairy consumption remains relatively low. The NZ Treasury reports that the only product the China consumes at a level comparable to other similar countries is whole milk powder.<sup>2</sup> For example, they estimate that if Chinese per capita consumption of SMP were to increase to the levels of Taiwan, it would increase world SMP consumption by 34% (of course, if this increase in demand was unable to be matched by increased production, it would be reflected in much higher prices).

An important factor driving income growth in China is ongoing urbanisation. But as well as high incomes, urbanisation brings with it big changes in lifestyle and diet. In cities people are more likely to consume food away from home, and consume different types of food. For dairy in particular, there is a large gap between rural residents' consumption of dairy products and urban consumption. In 2010, rural Chinese dairy consumption of dairy products (on a per capita basis) was approximately on a quarter that of urban residents. And with the Chinese government's agenda aiming for 60% of China's 1.4bn people to be urban residents by 2020, urbanisation is set to happen much more swiftly in China over the next decade or so, than would happen 'naturally'.

Of course demand is only part of the story. New Zealand's growing exports to China are also driven by the fact that domestic production has failed to keep pace with growing demand. But while Chinese milk production will undoubtedly continue to grow over the next decade, the Food and Agriculture Organisation expects the pace of that growth to slow substantially from 7%p.a. to 2%p.a. over the 2012-2022 period. We'll endeavour to explore the supply side of the equation in forthcoming *Fortnightly Agri Updates*.

**Global Dairy Trade Auction Results, 19 February**

	Change since last auction	Price USD/Tonne
Anhydrous Milk Fat (AMF)	-4.5%	\$5,314
Butter Milk Power (BMP)	3.1%	\$5,355
Butter	-3.8%	\$4,586
Skim Milk Powder (SMP)	-0.1%	\$4,780
Whole Milk Powder (WMP)	-0.3%	\$4,999
Cheddar	-1.70%	\$4,845
GDT Price Index	-1.2%	

**Payout Forecast Table**

	2013/14		2014/15
	Fonterra	Westpac	Westpac
Milk Price	\$8.30	\$8.40	\$7.10

Anne Boniface, Senior Economist.

# Beyond the farm gate



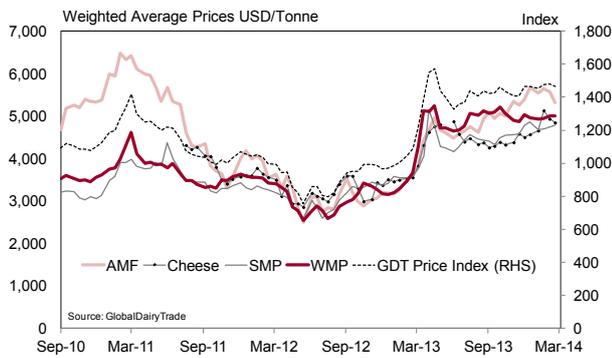
## Dairy

Current price level compared to 10 year average		Next 6 months
Trend	High	↘

There were few signs of prices easing significantly in the near term in last night's GlobalDairyTrade auction results which registered a 1.2% fall in dairy prices on a trade weighted basis. AMF and butter prices recorded some of the largest falls, while skim milk powder and whole milk powder prices were little changed (down just 0.3% and 0.1% respectively).

Domestically, Fonterra reported a 4.2% lift in milk volumes to 31st January. Some areas are drying out (including in the Waikato) however forecasters are predicting normal to above normal rainfall over the next 3 months. Internationally, the response of US producers to improved margins has been rather sluggish to date (not helped by very cold weather). However milk production in Europe has shown stronger signs of growth. In Australia milk production remains 3% behind last season's levels, not helped by very hot weather in Victoria (the state which produces the most milk).

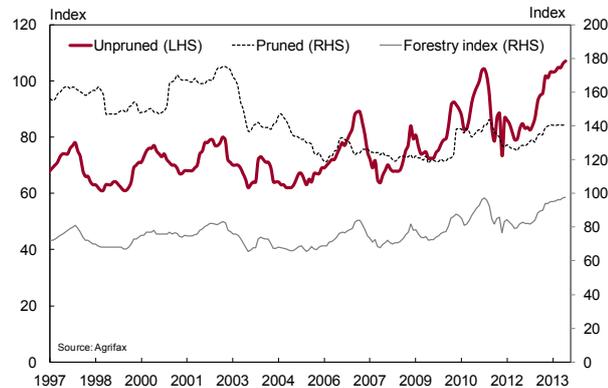
Looking ahead, with high prices now clearly being reflected in improved farm gate returns in many parts of the globe, we continue to expect producers to respond to improved margins by increasing output. This is likely to weigh on dairy prices from around mid 2014.



## Forestry

Current price level compared to 10 year average		Next 6 months
Trend	High	↘

Strong demand from China for NZ logs pushed log prices up over 20% during 2013. Strong demand from offshore (particularly China) and increased building activity locally (as the Canterbury rebuild gathers steam) is putting upward pressure on log prices. While it is difficult to see prices taking a large step up from these already high levels, prices may drift sideways over the next few months.

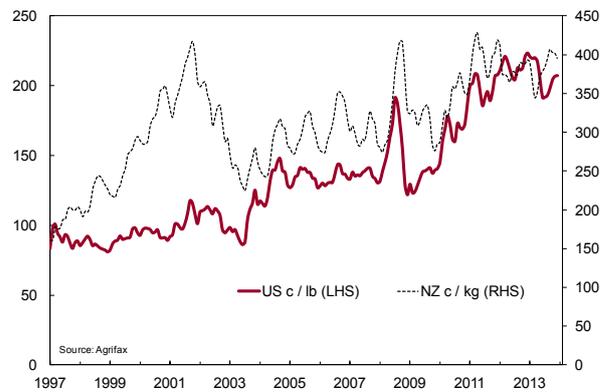


## Beef

Current price level compared to 10 year average		Next 6 months
Trend	Above Average	↑

US domestic beef supplies remain very tight, with cattle numbers starting 2014 1% lower than levels a year ago, which is flowing through to reduced slaughter numbers. This was the 16th year of decline in beef cow inventories since 1996, which will continue to weigh on US beef production over the next couple of years as producers gradually rebuild herds.

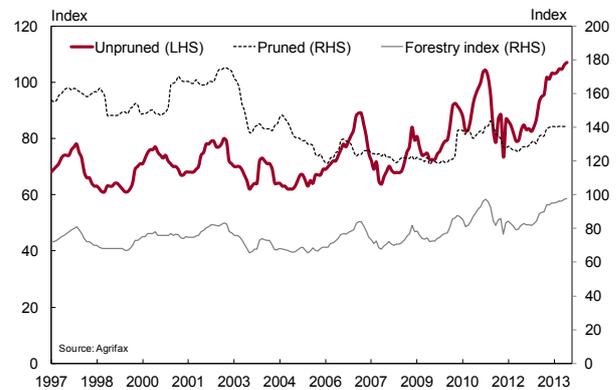
In contrast to tight US supplies, Australian beef exports were very strong in January, as drought conditions persist across much of Queensland. Australian producers are also optimistic about increased trade with South Korea on the back of an FTA due to be signed shortly by the two countries. While this is not great news for New Zealand producers, it could potentially provide opportunities in other regions if an increased proportion of Australian beef exports are diverted to Korea.



## Lamb

Current price level compared to 10 year average		Next 6 months
Trend	Average	↑

International lamb prices have continued to edge higher in recent months. Domestically tight supplies, a remnant of last summer's drought and good pasture conditions encouraging farmers to add more weight to stock, should underpin prices during the seasonal decline over the next few months. While the Eurozone remains unambiguously weak, the UK economy has shown some positive signs in recent months, which may support consumer demand for lamb. Tight supplies in NZ and Australia should also help underpin prices. Locally many farmers are looking to take advantage of good pasture growth to improve finishing weights.



NB: Trend arrows indicate direction of change in world prices.

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