Finding a brighter future - in commodities

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"Nothing can be created out of nothing."
Lucretius, who was not a Central Banker

Consumer wants in the USA

Over-investment, in extremis in telecommunications and technology, has resulted in overly-competitive pricing and falling profit margins. What demand there is in America is drawing in foreign goods, so keeping pressure on local firms who have little incentive to invest in new jobs while they operate below capacity. Elsewhere, the general response to pricing pressure by most countries has been to gain/retain market share by competitive devaluation, tariffs and other beggar-thy-neighbour policies. Effectively, margins are being squeezed by the deflationary power of poorer, populous countries that recently joined the world market. These countries produce more - and progressively much more sophisticated items - while their people work willingly for a fraction of the wages that we are used to - so denying producers elsewhere any pricing power.

Thus American consumers have helped to create a great economic success story - in China. Today, China consumes more steel and copper than the USA. Tomorrow - within 15 years - China will join Europe and the US as one of the great consumer societies with a reserve currency to match.

Meanwhile, US economic policy continues to stimulate credit growth and consumption by increasingly indebted households - rising debt is a cornerstone of US prosperity. It seems as though US economic policies are designed to impoverish the United States and to enrich Asia. "The US current-account deficit could approach 7% of GDP, requiring about $3 billion of foreign financing every business day. The world has never before faced an external financing burden of that magnitude." (Stephen Roach, Morgan Stanley). On balance, the US owes $42 trillion dollars to foreigners, net of US investments overseas - with no painless way of paying for it. As resources have been diverted from local capital investment to consumption, individuals have less real money to spend: that is the problem with a consumer economy.

Further, it is very difficult to reduce debt if producer prices are static or falling. But, Dr Ben Bernanke the Fed eral Governor warned last November: "we have... a printing press". Both gold and the euro rose as the foreigners appreciated what Bernanke was saying - that the Federal Reserve was ready to ruin the dollar rather than allow consumer prices to fall. For a country that relies on the kindness of strangers to live beyond its means, it doesn't seem wise to step on foreign toes. Further, the forces conspiring against business investment in the USA make lowering borrowing costs virtually irrelevant.

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Except for China and parts of SE Asia, the world economy is drifting into an era of slow growth. Everybody is depending on US consumers to keep buying... but Americans are running out of money. China is not complaining about western profligacy. It has the lowest labour rates in the world and a remarkably dynamic manufacturing sector. Its people save 25% of their incomes, cf. the most recent figure for Americans has risen recently to a high of 4%. China has linked its currency to the dollar, so a falling dollar makes Chinese goods even more competitive elsewhere. Other nations have to lower their currencies too, in order to avoid losing market share. Synchronous global currency debasement will do wonderful things... for gold and other commodities.

New Zealand will get the worst of all worlds if our Reserve Bank continues to accept an over-valued (though free-floating) dollar and to keep interest rates up to hold inflationary pressures from increased property and construction activity, and increased government charges. Reflexively, we turn to property as our favoured base for savings so pushing up house prices, especially in Auckland. Unfortunately housing does not provide the multiplier effect that sustains economic growth: unless we are to develop a burgeoning bed and breakfast industry for overseas tourists - in Remuera! It is the Baroque genius of New Zealanders that absurdity is no barrier to popularity. Complacency is endemic. The reported story of the sale of Dunedin Power was predictable: of individuals getting a $5000 cheque, a few would use it to redeem debt and the rest would buy household goods or take a holiday.

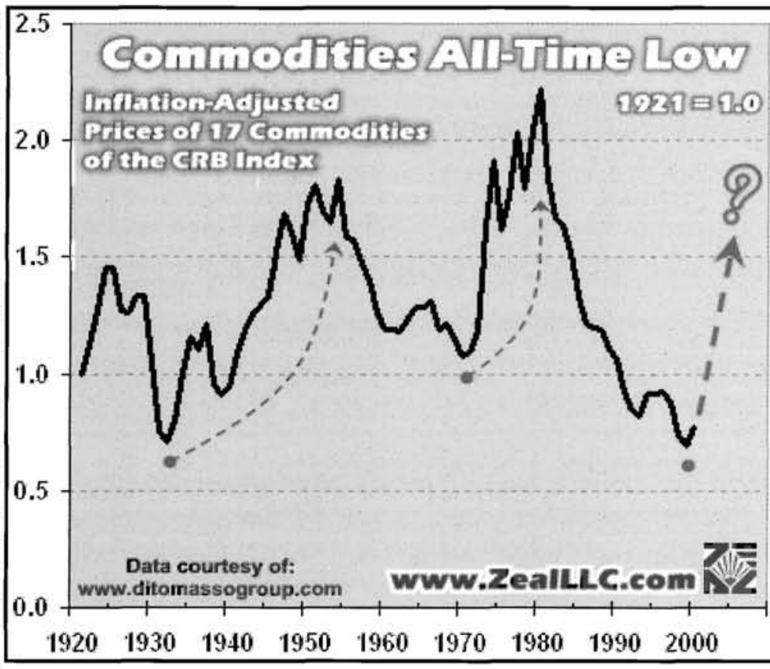
The larger issue is whether the economic cycle now favours hard-assets such as commodities - especially gold and silver - where there has been severe under-investment. While the Bernanke Fed can produce dollars at no cost, each new ounce of gold or packet of lumber arrives at market bearing the blood, sweat and tears of hard labour barely lubricated by jaded speculators and ever-hopeful farm-foresters. Like Lucretius, I prefer gold and other hard assets to the arbitrary nothingness of e-dollars from the Fed.

Commodity squeezes

Commodities have been abundant and cheap. Exactly. The Commodities Research Bureau index that tracks a basket of 17 commodities, when worked back to the 1920s and adjusted for inflation, hit an 80-year low in late 2001 - and bounced. The two 20th century booms in commodities arose from losses in the broader market, because prior to that moment:

- Crucial areas for the economy had been neglected as capital chased the popular bubble;
- prices of commodities were too low, often below the cost of production, often below replacement cost, and both production facilities and distribution infrastruc-

ture had been allowed to fall apart because they could not attract capital during the boom years;
- resources were creamed and degraded, cf. the felling of Douglas-fir in Kaingaroa and the extraction of only the richest lodes in a mine; and
- many companies drew down their resources and reserves faster than they replenished them.



Curiously, commodity prices doubled between 1932 and 1934, in the midst of deflation and the Great Depression. The decline in demand was met with a proportionately greater decline in supply.

Recent rising energy costs have compounded the effects of falling demand for other materials. Inefficient or poorly financed producers have been squeezed further. Mines closed. Exploration budgets were slashed. In New Zealand forests are felled younger. Minimal tending regimes are rationalised, to retain cash flow - treating forestry companies as short-term trading vehicles rather than long-term investments. Only when all short-sighted measures are exhausted will the Conceptual Mindset change.

One expects commodity prices to rise during periods of strong economic growth and fall during periods of weakness. However, recently commodity prices have been rising regardless of the world economy's uncertain growth prospects, with the CRB index of commodity prices moving up almost 30% from their recent lows. Probably, this is because commodity prices track nominal GDP more closely than real GDP - not too surprising given that the CRB index simply measures the nominal price of a basket of commodities. In effect, actual and expected rates of inflation have been heading higher, even as the world economy remains weak, and that's what is showing up in the CRB index. Inflation seems to be the message. One aspect of the current commodity rally is not widely appreciated: it is not just oil - most commodities are rallying to a lesser or greater extent.

The profitability of many western international traders has been sustained by outsourcing, by closing their own high-cost manufacturing facilities and moving production to Asian countries. However, since many of these companies formed joint ventures, knowledge, skills and manufacturing technology have been transferred to the local partners. It is through the process of outsourcing that Asian industries acquire the necessary means to produce goods under their own brands. Whereas the 1990s was the decade of the western multinationals and their brands, the next 10 years may see very powerful local brands in the domestic markets of emerging economies and the rise of Chinese brands on world markets. Life for the Old Multinationals will be ever more difficult.

Where-to-now for New Zealand forestry?

With anaemic economic growth in demographically-aging old Europe, Japan and North America, developing countries will find the real opportunities in their own emerging markets. But, New Zealand cannot expect necessarily to export much processed wood for consumption within these developing countries. We cannot compete with their ability to add value at much less cost. China attracts US$50 billion annually of new offshore investment in manufacturing, drawn there by cheap land, concessionary tax rates, better infrastructure - and uses the most advanced technologies. Further, it has an asset no other country - except possibly India - can claim, the largest pool of entrepreneurs and engineers in Asia, more even than Japan. Competitiveness is not due simply to low wages - a workforce prepared to do the job for 3% of Japanese wages - there is the wealth of talent too.

It is difficult - inconceivable - to believe that NZ wood processors will out-compete Asian business. Where is our competitive advantage? If plantation forests cannot meet the profit expectations of corporate CFOs, it is hard to see down-stream processing doing better in the long-term. It would be delicious irony if the future of forestry lay in log exports to China and India.

Procrastinators may argue that when the economic tide comes in it lifts all the ships. The trouble is that the prime beneficiaries are those closest to the low tide, the low-cost SE Asian economies. The only other safe-havens will be resource-rich countries like Australia, Canada, South Africa - and microstates with attitude. China is a price setter for finished products but a price taker for a wide range of soft commodities - sugar, vegetable oils, coffee; of natural resources - natural gas, lumber, pulp; and of industrial commodities - iron ore, metallurgical coal, copper. China's size and speed of development will devalue labour relative to scarce resources. China's household expenditure is much more resource-intensive compared to that in mature economies, and this is unambiguously bullish for commodities.

Commodities have two advantages: first, everyone needs them - and if you haven't got them then you cannot produce them; secondly, they are often a small part of the total costs (more price elasticity) - the silver content of a photographic film is only a few cents. This argument is less persuasive for soft commodities and forest products as they "suffer" from being renewable just as, in a parallel vein, gold "suffers" relative to silver as the former has been largely stored while silver is consumed in industrial processes (the use of CCA will be phased out in the USA by December 2003; if - a very big if - silver-based biocides were to be used instead, then 100 million ozs of silver would be consumed which is over 10% of world production). Although forests may lack the scarcity cachet sought by investors, New Zealand might hope to find relative advantage - in radicalising tree breeding, management and silviculture. For New Zealand forestry, my prejudices say we should aim for "shorter rotations, lower costs and superior quality for both eucalypts and pines."

Shortening rotations and simply treating our forests as commodities will offend some people. This scenario creates wealth by transforming our forest commodity base and by implication tilts at a down-stream value-adding strategy where we lack competitive advantage: it suggests a lower risk and more profitable future lies in upgrading the intrinsic qualities of our forests.

In the case of pines the sole focus should be on corewood. It was our technical inability to address corewood in the 1960s and 70s that drove modern silvicultural systems (prune and thin) for the next 30-40 years - systems that have been hugely successful in expanding the forest estate - but not in generating profits. At that time the alternative was a structural regime with high stockings, knot-control through branch-suppression after canopy closure, a 35-year minimum rotation and small final piece-size: giving stiff knotty outerwood and a suppressed volume of unstable, box-grade corewood.

Fortunately our tree breeders can - or are about to - deliver new families and clones that are transformational to the degree that the term corewood will no longer be relevant and there won't be any outerwood by the time the trees come down at age 15-18. Maybe, these trees ought to be pruned to 2.5m at age 4-5... Once breeders achieve a minimum threshold stiffness of 7 GPa by, say, ring 3 the constraint of holding high stockings for long periods needs no longer apply. The lower stem will be largely structural lumber, with long internodes higher up providing stable, distortion-free clearwood blanks. If "trees without corewood" had been available, the case for CHH's Millennium Forestry would have been that much more convincing.

Unfortunately there are too few risk-takers driving this transformation. To achieve this, foresters will have to pay top prices for the very best families and clones - and know in their hearts that that was the best investment they ever made (make choices, not decisions!). Looking further ahead, at least one generation of vastly-improved forests arising from the yet-to-be-planted elite "trees without corewood" is needed before we can turn to natural regeneration. Only then, can New Zealand move to an economic, sustainable, naturally-regenerating exotic forest resource.

In the case of eucalypts New Zealand has to recognise them as seriously complementing pine, playing on their desirable features of moderate density and clean trunk, so displacing much clearwood from pruned pine. Eucalypt sawlogs should be grown on a 12-15 year rotation. The fact that they are not is because growers (and their advisors) are trapped within their own logical rationalisations. Effectively they are locked in to sub-optimal forest operations that are doomed to disappoint. At a pragmatic level, this is an inditement of 50 years of eucalypt research into wood quality in Australia and New Zealand.

With the status quo, New Zealand is uncompetitive with growers in South Africa and South America. The constraints - growth stresses and collapse - are perfectly capable of considerable mitigation but there are no risk-takers to drive this transformation - only more eucalypt reports, more research and limited boutique plantings.

Naturally regenerating elite pines and genuine resource diversification with plantation eucalypts - to the chagrin of our neighbour - are worth striving for. Plantlets can be replicated cheaply because the best family crosses and individual clones don't obey the law of diminishing returns, whereas once planted in forests they lock up scarce capital. A nation's bright future is its youth (new breeds); it responsibility is to its aged (the existing forest resource) - but there is no intergenerational equity in forestry!

Foresters are prudent folk schooled under the "Great Ought" (visions of the Case Study). "Ought" is not a cheerful student in the Harihari pub - more one who denies you aspirin and is unsympathetic as you struggle up Mt Wilbur the following morning. Politicians don't like "Ought" either (shades of Ruth Richardson); they don't appreciate her moral tone and try to ignore her. To them, the economy is a giant machine with no heart, no soul, no right, no wrong; and economics is just a matter of pulling the right levers. Undoubtedly, the forest grower "ought" to be getting a better deal. Forestry is like a Morality Play built around IRRs, but foresters have to start out right. They ought to start with the right trees. If we don't create transformational forests then, maybe, our hitch-hiking bed and breakfast guest - in Remuera - will return to buy the place and we can retire ungraciously to Invercargill.

"There are things we know that we know. There are known unknowns - that is to say there are things that we know we don't know. But there are also unknown unknowns - there are things we do not know we don't know." Donald Rumsfield in an unusual role as poet. Living through the coming decade will be a lot more uncomfortable than visualising it. We ought to make it worth the ride.