



Agribiz

October 2012

Food for thought

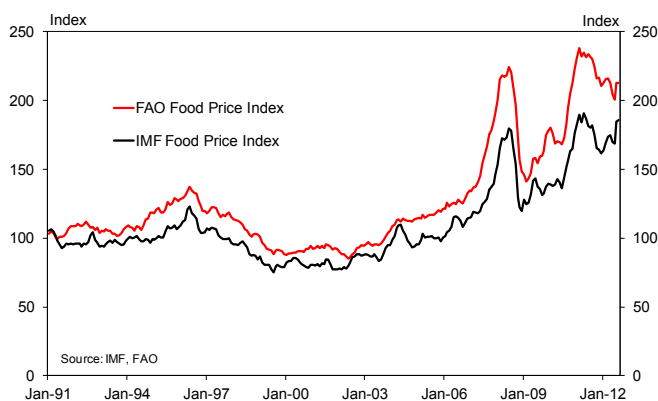
Global food prices heading higher

Global food prices are once again in the international spotlight, as prices for wheat, corn and soybeans have soared in response to adverse weather and deteriorating crop prospects. In this quarter's Agribiz we look at some of the risks higher global food prices bring for the global economy, and investigate what impact higher grain prices might have on prices of key New Zealand exports such as meat and dairy.

Droughts send grain prices soaring

Food prices are once more heading north. Driven by sharply higher grain prices, global food price indices are approaching all time highs. Some of the biggest moves have been for corn, soybean and wheat with prices for all three now markedly higher than just a few months ago (figure 2).

Figure 1: Food Price Indices



A key driver of the recent increases has been the US drought. About 80% of agricultural land is experiencing drought (including large swathes of the Great Plains and Midwest) which makes it the most extensive drought since the 1950s. Arriving in June, the drought rapidly worsened in July and has persisted since then. It has left corn and soybean crops severely damaged and seen forecasters make sizable downgrades to their production estimates. The closely watched US Department of Agriculture's forecasts of soybean production are now for a 13% fall by 2012/13 compared to 2011/12, while the corn harvest is expected to drop 14% on the previous period.

Figure 2: Corn, wheat and soybean prices

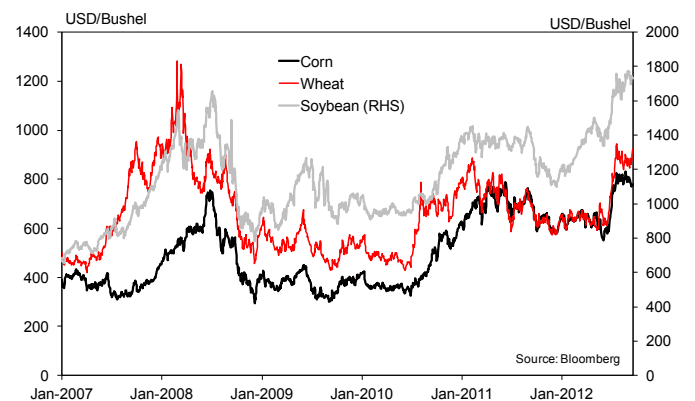
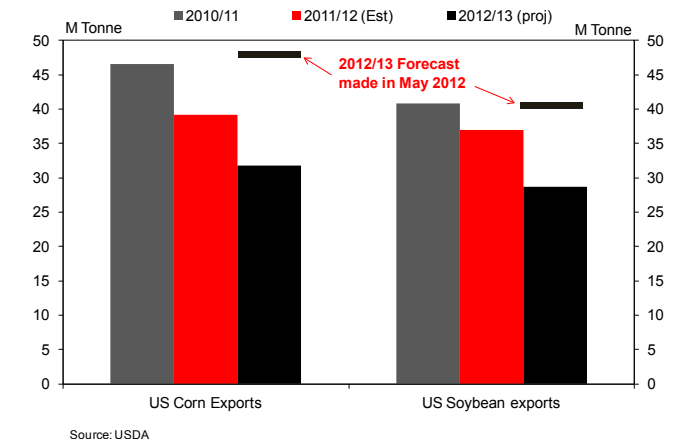


Figure 3: USDA Revisions of corn and soybean exports



But adverse weather conditions haven't just been restricted to the United States. Wheat prices are also higher on the back

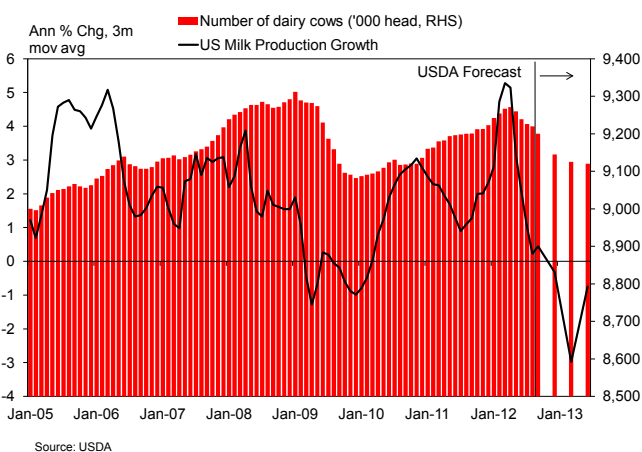
of deteriorating crop prospects in parts of Russia (the world's third largest wheat exporter), Kazakhstan and Europe. The UN Food and Agriculture Organisation (FAO) expects Russian wheat output to be 29% lower this year than in 2011, and production in Kazakhstan and Ukraine is expected to fall by 47% and 37% respectively (not quite as severe as in 2010, but big falls nonetheless).

Higher grain prices to be felt further afield

Of course the effects of sharply higher grain prices have an impact on agricultural markets more broadly – and have important implications for New Zealand farmers. Internationally, grains are a key input into the production of milk and meat as well as biofuels.

Higher feed prices are likely to push up costs for US (and European) producers who were already being squeezed by lower milk prices. Higher feed costs act as a drag on production growth – and we've already seen this starting to take effect. Growth in milk production in the US has slowed markedly over the last few months, as cattle struggle with the heat, feed costs have skyrocketed and growth in dairy herd has slowed (figure 4). This means less milk is likely to find its way onto global markets, putting upward pressure on prices. Compare this to the last 12 months, where a veritable tsunami of milk was being produced in a number of key dairy exporting regions. High prices boosted margins for Northern hemisphere producers, encouraging them to lift production, while unusually good weather conditions were a boon for southern hemisphere production. Overall supply conditions are set to change quite significantly.

Figure 4: US milk production growth and dairy cattle numbers



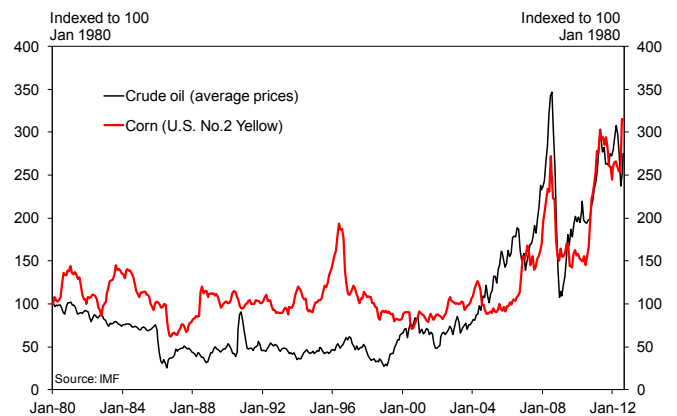
In addition, we expect the demand backdrop to also have a more positive tone next year on the back of improved growth prospects in China and other parts of Asia. While this will still mean that 2012/13 is a challenging year for New Zealand farmers (we're forecasting a drop in the payout to around \$5.70), improved international dairy prices in 2013 should translate to a higher payout in the 2013/14 season.

The ripple effect of higher grain prices in meat markets can take longer but ultimately leads to much the same outcome. For meat producers, the easiest way to reduce feed costs is by cutting the number of mouths to feed. And we have seen US cattle producers do this in the past. In the short term of course, culling cattle adds to rather than reduces the supply of meat on the market, putting downward pressure on prices. However over a longer horizon, it reduces cattle numbers and tightens supply, effects we have seen during previous US droughts.

Food and oil

Grain markets are now also closely linked to energy prices because of their use in biofuel production. Grain and oil prices now move together much more closely than in the past. In the US for example, 13bn gallons of biofuel must be produced this year under rules designed to reduce both carbon emissions and the country's reliance on imported oil. This will require the use of around 40% of the US corn harvest, and must be produced, no matter what the price of corn. This additional demand (which is relatively insensitive to changes in price), adds to the upward pressure on prices and can create tensions between users. US cattle producers (and even the UN) are currently lobbying government for the biofuels quota to be suspended given the recent moves in grain prices.

Figure 5: Oil and corn prices



Response to higher prices

The sharp rise in grain prices should generate both a demand and supply response. High prices will encourage producers who are able to increase supply. For example, not all wheat producing regions have been impacted by poor weather. In the US, Canada, India and China wheat production is expected to be up this year compared to 2011 though the International Grains Council is forecasting total global wheat production to fall 6% by 2012/13.

Some producers will also be able to switch between plantings to maximise their profitability. Alternatively, they may convert land to entirely different uses (something we've observed in New Zealand as land has been switched into dairying from other types of farming). The speed with which these changes

can be made will vary and may depend on factors such as the length of growing cycles, the type of production methods in place and how long higher prices are expected to be maintained. For example, the current US drought is an exceptional event. Its impact on prices has been rapid and sizable, but it is unlikely to be sustained. Instead, as weather conditions return to normal, the impact on prices is likely to fade. In contrast we expect some of the fundamental changes such as urbanisation, population growth and increasing incomes in emerging markets, which are supporting increasing global demand for food, to be more long lasting.

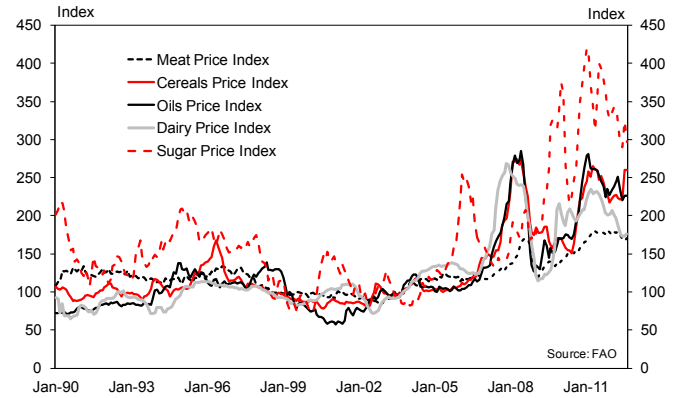
Higher prices will also weigh on demand. Where possible, consumers may look to substitute into cheaper alternatives or will simply have to spend less on other goods and services. Consequently higher global food prices weigh on growth and contribute to higher inflation – especially in countries where a big chunk of income is spent on food. This can create challenges for inflation targeting central banks, potentially reducing their flexibility to lower interest rates to stimulate growth.

But the response of both producers and consumers can be confused by protectionist policies being introduced. In the past, countries (including Russia) have reacted to poor domestic harvests by implementing restrictions on trade, with the aim of protecting domestic supplies. In other countries governments have intervened by attempting to insulate consumers against rising food prices (e.g. through subsidies or price controls). However such policies can prove to be very expensive, and ultimately unsustainable.

Protectionist policies tend to lower domestic prices in the “protected” country, but exacerbate price increases on the global market. Domestic price signals, which may have otherwise acted as an incentive for producers to increase production or for consumers to change their consumption patterns (eg by substituting toward less expensive alternative foods) are interrupted. Subsidies can also become very expensive for governments to maintain (though if the country is also a producer, there may be some partial offset from increased tax take from domestic producers, or an associated appreciation in the exchange rate which helps by lower the cost of other imported products).

We saw these types of policies introduced in response to the 2007/08 food price crisis. Then, a widespread spike in global food prices was caused by a combination of droughts, rapidly rising oil prices (which boosted the cost of fertilisers and transport and encouraged the use of grains in the production of biofuels) and, most importantly, strong demand. In contrast, the current episode is probably more aptly categorised as a supply shock. Food prices have moved higher in response to reduced output rather than a marked increase in demand. Another important difference between the current situation and 2007/08 period is that price increases have not been as wide spread. In particular, the price of rice (a key staple, especially in Asia) has remained relatively stable, with existing rice stocks at comfortable levels. Oil prices are also not at the same dizzying heights we saw in 2008. This helps keep a lid on transport costs and keeps fertiliser costs at more affordable levels.

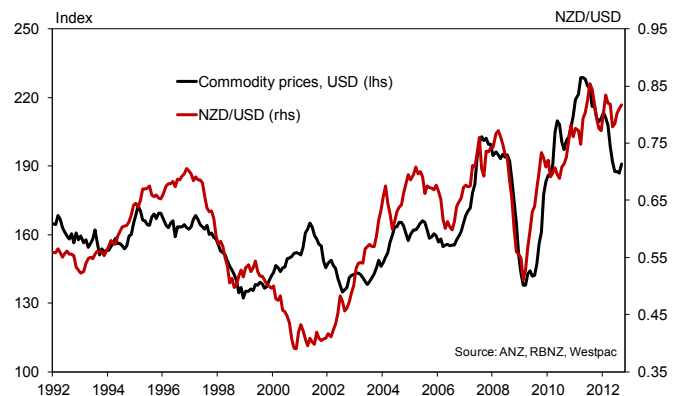
Figure 6: Components of FAO Food Price Index



NZ impact

As a net food exporter, higher global food prices provide an income boost to “NZ Inc”. We expect food prices to rise further over late 2012 and into 2013 and eventually to be reflected in an improvement in New Zealand’s terms of trade (the ratio of the price of the goods New Zealand exports relative to the price of imports), arresting the downturn we have seen since mid-2011. And this in turn should support the New Zealand dollar. A higher New Zealand dollar improves the purchasing power of those with New Zealand dollars to spend (and provides a buffer against the rising cost of imported food), but squeezes import competing firms and the revenues of exporters.

Figure 7: NZD/USD and export commodity prices, inflation-adjusted



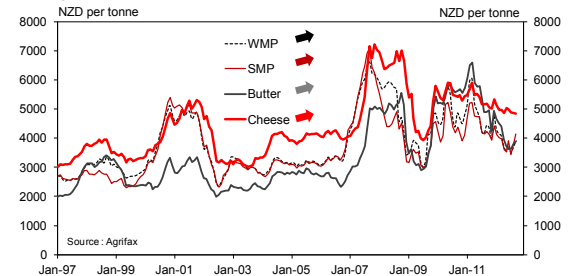
And while we continue to believe that demand growth for New Zealand’s key food exports will outstrip supply over the next few years, translating to higher food prices on average, volatility around this higher average level will continue. As the current episode demonstrates, unforeseeable weather related supply disruptions will mean prices spike higher at times (and there will be periods where increased supply weighs on prices).

Beyond the farm gate

Dairy

World dairy prices are recovering after hitting lows in mid-2012 with GDT prices up 18% over the last four auctions. After a bumper 2012 worldwide production season, the curse of drought has hit several grain-producing areas, particularly the US. As a result, the outlook for the current 2012/13 season is for improving world dairy prices. However as is often the case, the dollar has followed dairy prices higher, tempering some of the gains. In the 2013/14 season and beyond, prospects are firmer. With a recovery in global growth and ongoing income growth in emerging markets, particularly China, we expect increased demand to underpin prices.

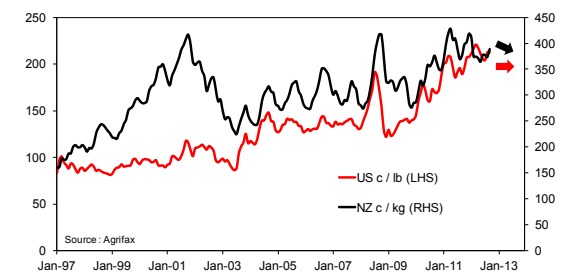
Dairy



Beef

Despite the New Zealand dollar holding firm above US\$0.80, beef farmers continue to benefit from historically high world prices. The outlook is for world prices to remain high as drought hits the US, bumping up the costs of US beef production (discussed in main text). This may force farmers to cull some stock, but with the US cattle herd already at its smallest size in 60 years the impact on prices may be small. From 2013 onwards, we expect beef demand to improve in tandem with an improving world economy. The hangover from the small herd size and high feed costs will make it difficult for US farmers to rebuild herds and keep up with this improving demand. This may mean opportunities for New Zealand beef farmers to fill the breach and benefit from higher prices.

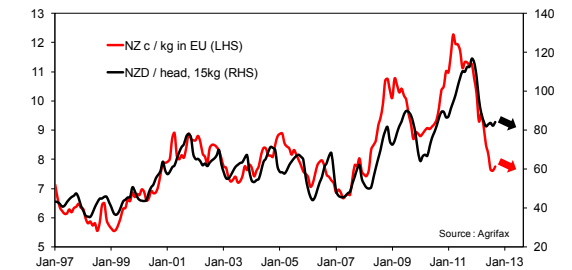
Beef



Lamb

After falling from late 2011 and most of 2012, lamb prices stabilised at a level slightly above the 10-year average. However, with the economic storm clouds continuing to rumble over Europe and the prospect of more rain (we forecast the Euro zone economy to contract by 0.7% over 2012), world lamb prices appear headed lower. Also, with Australian lamb slaughter forecast to increase 6% over 2012/13 competition will be hot in other markets (US and China) where we might have otherwise expected to pick up some of the European slack. The prospects further out are better with European growth beginning to recover from 2014 and emerging markets, particularly China, increasing their demand for protein.

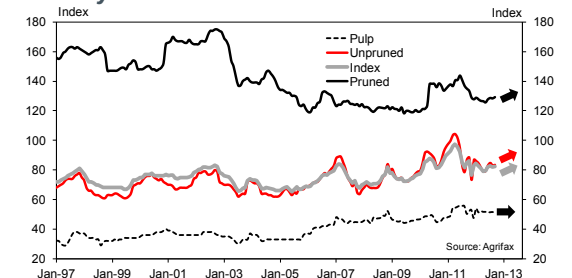
Lamb




Forestry

Log prices stabilised in mid-2012, and if you get your magnifying glass over you might even see a small improvement since then. Prospects hinge on the Australian housing market outlook and Chinese demand for logs. While the Australian market may remain weak into 2013, we expect that prices may gradually improve next year as policies designed to support growth in China start to gain traction. In addition, shipping prices have fallen and are helping to offset some of the impact of the high New Zealand dollar.

Forestry



Forecast Key:

 General pace and direction of prices expected over the next 12 months

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