

Agribiz

June 2010

Demanding an answer

- The makeup of the countries NZ exports to has changed dramatically.
- We are now much more reliant on the fast-growing developing countries than the slow-growing old rich countries.
- The latest sovereign debt crisis provides a good example of New Zealand's new-found resilience.
- World growth is likely to continue to be dominated by the developing economies, which is good news for NZ commodity prices.
- It's a case of back to the future for the New Zealand economy, with rural sector performance leading the way.

A Greecy slope?

Throughout the month of May, financial markets worked themselves into a funk. World equity prices dropped 15% in the month.¹ Numerous factors can explain the bout of angst, including:

investors having gotten a bit too comfortable about the global recovery story; geo-political risk on the Korean peninsula; worries that Chinese growth may be facing a hard landing; and huge concerns around the massive buildup in public sector debt, particularly in Europe.

We think the Chinese growth fears have been overplayed (after all, annualized growth of 12% in the Q1 2010 was unsustainable and needed to be pulled back). The Chinese authorities appear to have successfully engineered a moderation in growth, and can increase stimulus if required.

We have been a bit surprised about the level of investor response to the European sovereign debt crisis. To us, there has been a limited amount of 'news'. A year and a half ago we knew European banks had made inadequate provisioning for their exposures (particularly to Eastern Europe, the Baltic States, and the PIGS - Portugal, Ireland,

Greece, and Spain). The parlous state of many European governments' finances, amongst others (see *Figures 1 and 2*)², was also well known. Growth prospects for Europe were therefore already considered to be dim.

Figure 1: Gross Government debt, 2011

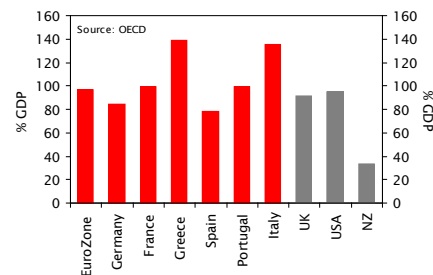
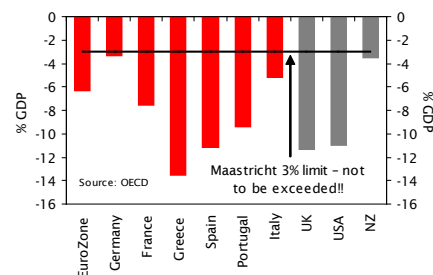


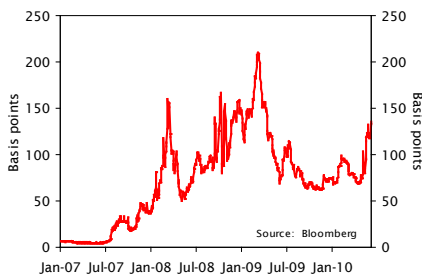
Figure 2: Selected budget deficits: 2009



The most disconcerting element of the sovereign debt saga was the initially piecemeal and sometimes unhelpful policy proposals by authorities (e.g., ban on naked short selling, bank tax, restrictive budget in Germany, perceived lack of preparedness to act by the ECB). Investors have currently got themselves into a state of mind where they are concerned if individual governments are not doing enough to restore their fiscal accounts to health, but equally concerned if too many governments embark on fiscal austerity programmes at the same time (because of the risk to global economic growth)! But a lack of balance is what you get at times of brittle nerves. We think this will pass.

What does all this mean for New Zealand? The comforting and surprising answer is, at present, "not a lot". Longer term funding costs for New Zealand banks in the wholesale markets have gone up (see Figure 3) by around 0.5 of a percentage point over the past month. However, the big NZ banks have got plenty of long-term funding already on board, so are not borrowing at these elevated levels. If the market ructions were to persist, then NZ borrowers would be faced with higher borrowing costs. There is an outside chance that the European situation deteriorates markedly and is the catalyst for derailing the global economy. We subjectively put the odds of a breakup of the Eurozone at less than 10%.

Figure 3: Five year credit default swap spread for the major Australasian banks



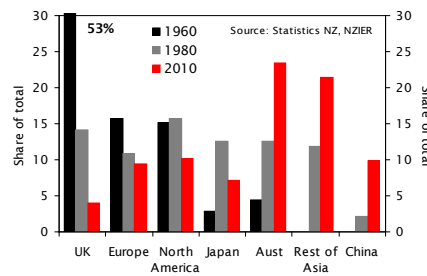
So far the impact of the sovereign debt crisis has been predominantly positive for farmers. The main response has been a lower NZD. The NZD has fallen further than our commodity prices, helping push New Zealand commodity prices in local currency terms even higher.

If NZ were faced with the same set of circumstances (i.e., very weak European, UK, and Japanese economic growth) in our not-so-distant past, we would have been severely affected by a drop in demand for our commodities. But the world we face now is a very different one.

Changing face of NZ export markets

New Zealand is now far less dependent on the 'old rich world' than at any time in its past (see Figure 4). Back in 1960, 87% of our physical exports went to the UK, Europe, North America, and Japan. Those countries now take less than a third of our exports. In 1960, Asia (ex Japan) and Australia took 5% of our exports and that has now soared to 55%. And New Zealand's diversification of its export markets has extended much further than Asia. A rising proportion of our exports is going to the oil-producing economies. For example, the share of dairy exports going to China and the oil-producing economies in the year 2000 was 20%.

Figure 4: The changing face of New Zealand exports



Just a decade later those countries share has, incredibly, doubled to 40% (see Figure 9).

Figures 5 through 8 show the changing export destinations of our meat, wool, wood and dairy exports over the past two decades. For all primary exports, we can see the rising importance of Asia as a destination - particularly so for dairy, wood and wool. Most striking has been the meteoric rise of China and this is expected to continue, augmented by our free trade agreement with China.

Meat is still our primary sector category most reliant on demand in the rich world (see Figure 5). Europe (including the UK) and North America account for two-thirds of our total meat exports, barely changed from 20 years ago. Thus, the slower growth in the developed economies would adversely impact our meat returns more than our other commodity returns. Fortunately, a lack of supply is currently helping offset lower consumer demand.

Figure 5: Meat

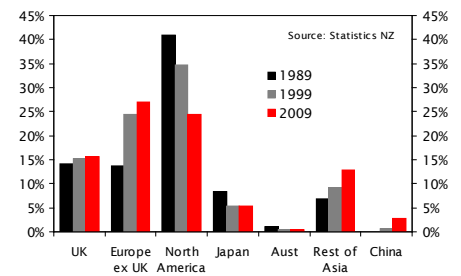


Figure 6: Wood

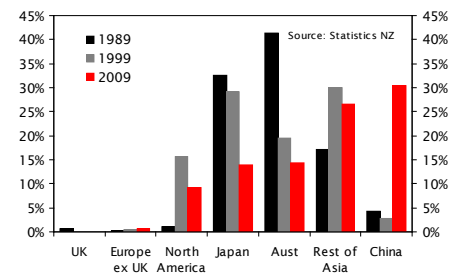


Figure 7: Wool

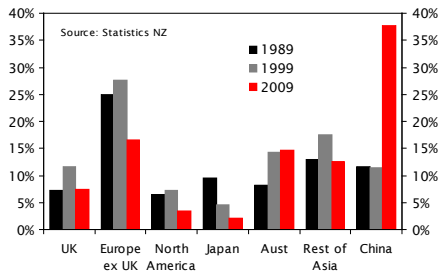
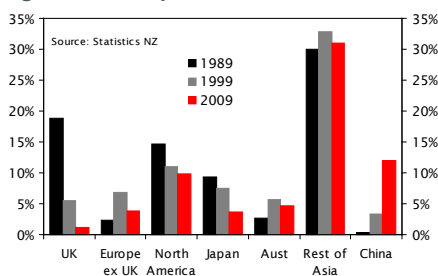
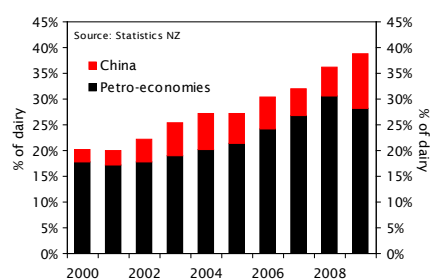


Figure 8: Dairy



For wool and wood, we have to be aware that not all exports are to meet final demand in the importing country. Some of our exports to other countries (e.g., China) are for processing and then re-export to developed economies.³ So crises in developed economies can still have an immediate impact on demand. Nonetheless, the extent to which New Zealand commodity exporters have switched to selling to developing economies is stark. This has meant higher average selling prices for farmers.

Figure 9: Destination of New Zealand dairy exports



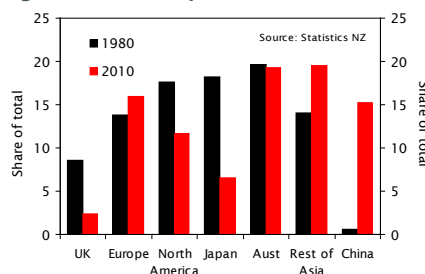
Import-ant

As an aside, the origin of our imports has been going through a similar transformation to that of our exports destinations (see Figure 10). 58% of our imports came from the US, Japan, UK, and Europe in 1980. This has declined to a 36% share in the ensuing three decades. In contrast, our imports from Asia (ex Japan) and Australia have risen from a 34% share in 1980 to 54% currently.

New Zealand is currently running a trade surplus in its dealings with Australia and Asia (ex Japan) in total. With 55% of our exports going to the region and 54% of our imports originating there, the trade balance is modestly in NZ's favour.⁴

The dramatic rise in New Zealand's trade flows – both export and import – with our Austral-Asian partners is a dramatic representation of our rapidly rising integration with the region.

Figure 10: NZ imports



Seismic shifts in relative prices

Another way of illustrating the seismic shifts in the global economy that New Zealand has been responding to is via the Global Terms of Trade (GTT). The GTT is a summary of trends in relative prices in the world.

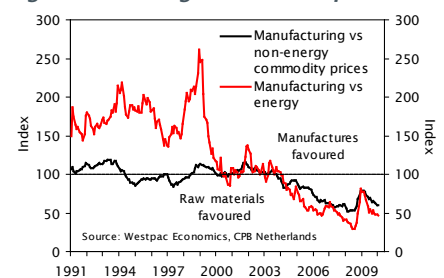
Over the broadest sweep of time, agricultural commodity prices have tended to rise more slowly than most

other prices in the world economy. This has meant that the 'agriculture terms of trade' (i.e., agriculture prices relative to other prices) has declined over the past few centuries. This 'normal' state of affairs has been flipped on its head over the past decade.

Figure 11 shows the price of manufactured goods relative to both energy and non-energy commodity prices (including agriculture). In stark contrast to most of history, commodity prices have been rising while manufactured goods prices have tended to be falling over the past decade. A notable exception occurred in the midst of the Global Financial Crisis. Commodity prices plummeted while manufactured goods prices only declined modestly. However, most of that GFC bounce in the manufactured terms of trade has now been unwound.

We think the main factor explaining this massive shift in relative price trends has been the rise and rise of China and other developing economies. They have been resource hungry to drive their industrialization growth strategies, placing huge additional demand on commodities (and pushing up their prices). At the same time, they have brought an enormous amount of (cheaper) productive capacity into global manufacturing – pushing down the relative price of manufactured goods. China and other developing economies

Figure 11: The global terms of trade



are still only at the early stages of their economic transformation. For example, another 260 million rural Chinese are expected to move into the cities by 2030. We expect the next 20 years to be characterized by relatively elevated commodity prices and relatively cheaper manufactured goods.

Where is growth expected to come from?

Given that we have hitched our commodity wagon to the developing economy horse, it's natural to ask where world growth is expected to occur. Importantly, the global recovery was never a European growth story. Back in October last year, the IMF was forecasting calendar 2010 growth for the Euro area of 0.3% and 1.3% in 2011.⁵ Europe was always going to be a drag on a world growing at an average of 4% in 2010.

Consensus forecasts (see Figure 12) are clearly for continued growth out-performance by Asia (ex Japan) and Australia. We concur. One response to the sovereign debt crisis will be for the developed economies to keep their interest rates at extraordinarily low levels for even longer. Developing economies, in the desire to prevent excessive exchange rate appreciation, have effectively adopted this super-easy monetary policy. Table 1, showing inflation-adjusted short term interest rates, points out the extent to which monetary policy has been kept lower than it ideally should if just domestic factors were taken into consideration. A prolonged period of negative real interest rates in these Asian economies risks causing asset price bubbles, with negative consequences a number of years down the track if the bubbles grow too large and burst.

However, for now, the debt crisis is likely to result in continued low interest rates and high growth in the developing economies.

Figure 12: World growth forecasts

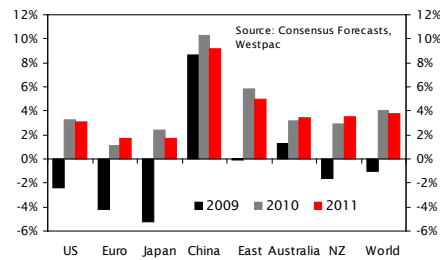
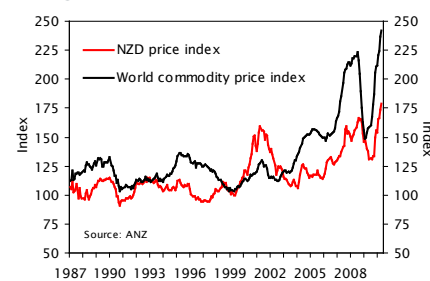


Table 1: Real short term interest rates

| | |
|-------------|------|
| China | 1.9 |
| Hong Kong | -2.3 |
| India | -4.0 |
| Indonesia | 1.1 |
| Malaysia | 0.3 |
| Philippines | -0.6 |
| Singapore | -2.2 |
| South Korea | -0.4 |
| Taiwan | -0.5 |
| Thailand | -2.1 |

Source: May 2010 Consensus Forecasts

Figure 13: Commodity export prices stronger



Looking good

We have been very optimistic about New Zealand's potential export performance for a long time. Our commodity prices

are at multi-decade highs (see Figure 13), a remarkable achievement just a year and a half past the worst of the global financial crisis and in the midst of the current sovereign debt woes. This latest episode is a good example of NZ's new found resilience. We are by no means saying that NZ is immune to global shocks. Rather, we are less susceptible to shocks from Europe and North America than we used to be.

By being tied into the fastest growing region of the world, we can enjoy higher average commodity prices and economic growth than we otherwise would have. While we think the demand backdrop will remain favourable for our commodities (barring GFC mark III!), prices will still be swung around by gyrations in supply. The downside of our newfound Asia focus is that when there is a crisis in this part of the world, we will be badly impacted. We can't envisage that happening for years yet. In the meantime, we'll continue to enjoy the ride.

¹ As of time of writing on June 9, they were still 15% down on their April average.

² Net government debt would be a better measure than gross debt, but we do not have a consistent series available for all countries. Gross government debt for New Zealand in 2011 is projected to be 33% whereas net debt is expected to be 20%. While New Zealand's government accounts are in relatively rude health, our total level of indebtedness is more worrying. New Zealand's net foreign liabilities (the difference between how much we own of the rest of the world compared to how much they own of us) stands at 90% of GDP.

³ A greater proportion of hard than soft commodities are re-exported, which is why their prices have taken more of a hit during the ructions of the past month.

⁴ In total against all countries, New Zealand ran a trade surplus of \$160 million in the year to April 2010.

⁵ Revised up to 1.0% and 1.5% respectively, before the latest bout of panic.