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CLIMATE OF CHANGE

FEATURE ARTICLE: BIG THEMES OF 2013

We outline some of the key themes that will play an influential role in determining New Zealand's economic prospects over the year ahead. They are: The circle of "[dis]Trust"; Transitioning via differentiation – some unheralded legs of the growth story for New Zealand; Sovereign risk (a repeated theme three years running); Asia's upside for New Zealand – shifting attention from the Macro to the Micro; A polarised compass; and Jobs. The bottom line: brace for another bumpy year, which whilst better than 2012, we would still characterise as a grumpy growth environment.

THE MONTH IN REVIEW

The North Island has begun to dry out again after good rain in late December, whereas most of the South Island received good rain in mid-January to keep things going. Dairy farmers' fortunes have improved despite mixed weather and a fright from the discovery of DCD in milk. Things have not been so chipper for sheep farmers as the realisation of lower sheep and wool prices has set in.

RURAL PROPERTY MARKET

Activity data from the rural property market has been painting a stronger-than-expected picture. Overall the number of farms sold and average price have strengthened over the past three months and when compared with last year. However, price movements have been somewhat uneven across the different land types and regions, reflecting the lack of a clear trend driving the market.

KEY COMMODITIES AND FINANCIAL MARKET VARIABLES

We expect the NZD to remain elevated, although the outlook has shifted subtly to one of stability as opposed to one of further strength. The global picture for soft commodity markets looks more positive heading into the first half of 2013, but economic growth across the major economies will need to hold together.

BORROWING STRATEGY

While the floating rate has been stable, wholesale term interest rates have risen since our last update. While this does make fixing relatively less attractive, with less than 0.7 percent separating the lowest and highest interest rates, the reality is that the decision to fix depends more on one's appetite for certainty. We expect to see floating rates rise eventually, and fixing some debt for 1-2 years now has some appeal. But with OCR rises some way off, time remains on the side of borrowers.

EDUCATION CORNER: CLIMATE CHANGE UPDATE

On the international scene, NZ has recently pulled out of a second commitment period under Kyoto. Those with binding commitments now encompass a very small proportion of global emissions, reducing its perceived relevance. It also lacks a compliance mechanism. Although the New Zealand Government remains focused on achieving an "international, legally binding agreement by 2020", it is changing its strategy, preferring the UN Framework Convention stream that includes 85 percent of global emissions to achieve this. On the domestic scene there have been some recent amendments to the NZETS that will influence landowners' investment decisions. We detail these changes, but in general they have been designed to ensure the least amount of change within the ETS to mitigate its impact on the NZ economy, which whilst improving, is still fragile.

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SUMMARY

In this section, we outline some of the key themes that will play an influential role in determining New Zealand's economic prospects over the year ahead. They are: The circle of "[dis]Trust"; Transitioning via differentiation – some unheralded legs of the growth story for New Zealand; Sovereign risk (a repeated theme three years running); Asia's upside for New Zealand – shifting attention from the Macro to the Micro; A polarised compass; and Jobs. The bottom line: brace for another bumpy year, which whilst better than 2012, we would still characterise as a grumpy growth environment. Common sub-themes across all thematics are expectations of low interest rates, the rising significance of a microeconomic story supporting the macro one, and volatility.

This article appeared in our *Market Focus* publication at the end of January. Its contents are highly relevant to the rural sector. Our key aim in writing this article is to alert our readers to some of the wider economic forces at work. We want to highlight the inherent tensions that exist within the economic system, and to encourage farmers to start thinking about the implications for their business. The themes are:

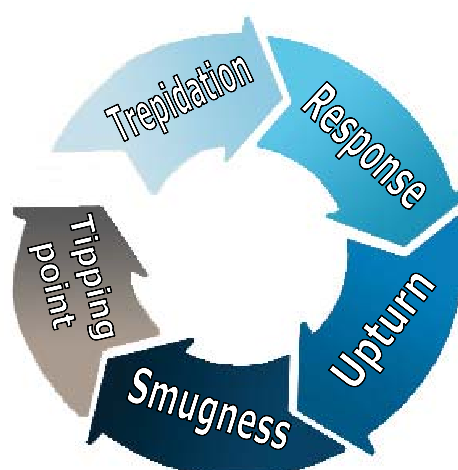
- **The circle of "[dis]Trust".**
- **Transitioning via differentiation: unheralded legs of the growth story.**
- **Sovereign risk.**
- **Asia *et al* – shifting New Zealand's attention from the macro to the micro. It's all about execution.**
- **A polarised compass for the New Zealand economy.**
- **All about jobs.**

THEME 1: THE CIRCLE OF "[DIS]TRUST"

The upshot: The Western world is facing Groundhog Day where we circle through a five-stage process: trepidation, response, upturn, "smugness", tipping point, and back to trepidation, setting the spiral in motion. Given weak debt fundamentals, breaking the spiral requires fiscal competency and credibility, and a mandate for economic reform. That's a tall order to get a political mandate for. Lacking these circuit breakers, we continue to morph through the various stages. The cycle flags continued volatility, with financial market variables relevant to New Zealand (i.e. the NZD) oscillating as opposed to trending. Interest rates will need to remain low. This cycle will also continue to drive the demand side of the equation for commodity markets.

There are five legs in the circle of "[dis]trust".

- **Trepidation – a focus on the fundamentals:** Western society needs to face up to the realities of a low growth trajectory in a world of ongoing deleveraging. Basic maths tells us that fiscal positions are not sustainable in a host of nations including the US and Japan, the largest and third-largest economies in the world. Growth models that include protectionism, labour market rigidity, massive social entitlements, and a huge role for the state are under the spotlight. OECD countries are still borrowing faster than they're growing; we're seeing limited fundamental reform to lift growth capability across Western society (a necessary ingredient for fiscal sustainability); we have polarised political systems which lack a consensus; and large parts of society are still in the denial stage of the post-GFC grief cycle.
- **Response:** Central banks cut interest rates and crank up the monetary printing presses.
- **Upturn:** Systemic risks are contained. Green shoots appear. Markets breathe a sigh of relief and rally. Investors and businesses see opportunity.
- **Smugness:** Complacency appears. Lacking the market mechanisms to foster the required change, the pace of reform wanes and draws to a standstill. Populism prevails over leadership.
- **Tipping point:** The rubber band again becomes taut. Fundamentals usurp sugar-pill economics. Green shoots turn brown and we swing once again to trepidation.



In the process, markets (and society) lurch from risk-on to risk-off (somewhat simplistic terms in our view) and back again, **navigating an environment of poor fundamentals** – including massive global

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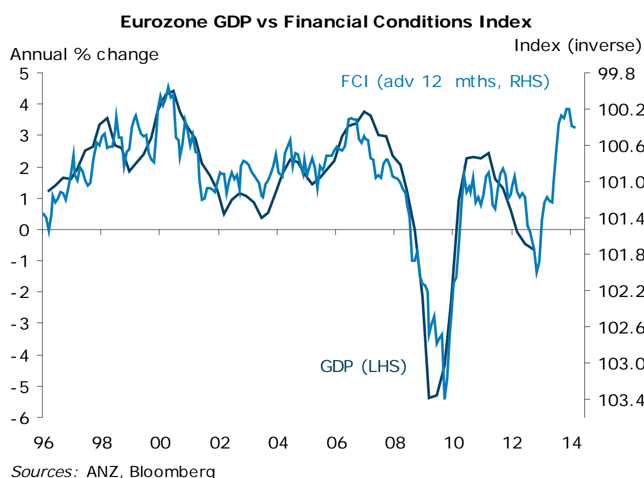
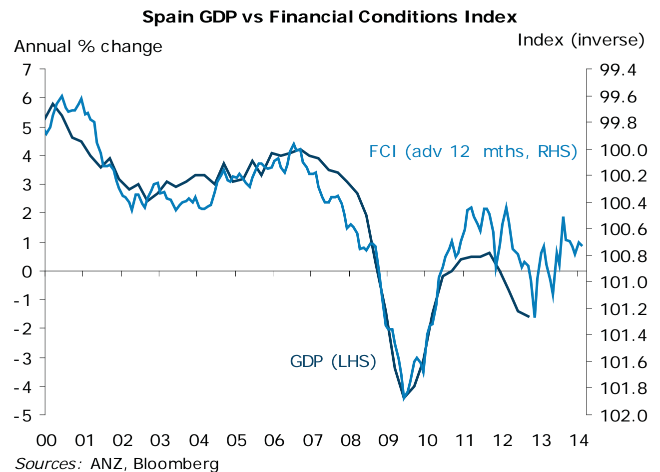
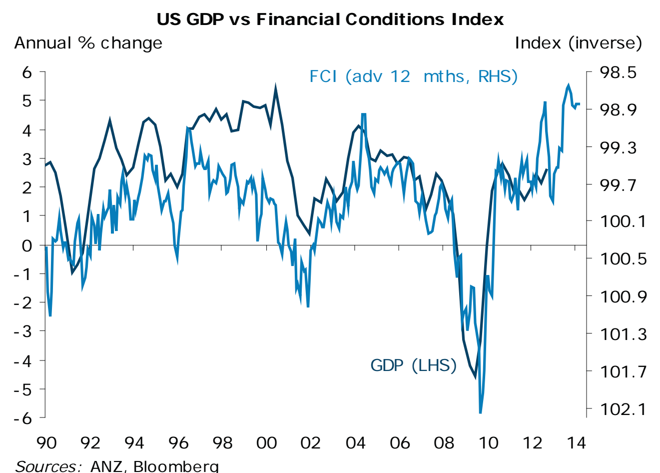
imbalances between the USA and Asia (the USA current account deficit soaks up around 3.5 percent of estimated global savings!), **fiscal profligacy, significant monetary policy stimulus and liquidity, a lack of political awareness** and consensus, and game theory that sees **self-interest trump group interest. This lurching has seen the likes of the NZD/USD range from 0.76-0.85.**

Of course we are seeing improvement in a host of areas. The provision of liquidity has helped calm financial markets. Equities are on an upward trajectory. **Tail risks in Europe have diminished.** We are seeing some semblances of political cohesion. The ECB's proposed bond-buying scheme has seen a sharp tightening in peripheral bond spreads, the ESM bailout-fund has been given the green light, and plans for a regional banking supervisor in Europe will help plug the bank-sovereign loop. The financial plumbing is once again operational. We're seeing wages adjust (decline) in Greece and Spain as unit labour costs between the periphery and core converge. **The outlook for the US economy has also improved.**

Financial conditions in Europe and the USA are flagging the potential for strong growth, though this is not occurring in some pockets of the Eurozone periphery. Loose financial conditions would typically portend of a strong economic rebound, though we need to recognise that **such measures lack key structural elements** such as balance sheets that are currently a material restraint on growth. Excess liquidity is being channelled into debt repayment (not investment), some speculative asset classes (i.e. Hong Kong property) and commodities. Lifts in the latter are an implicit tax on Western society though a plus for the likes of New Zealand!







Complacency (smugness) looks to be setting in with US "fiscal cliff" issues averted and the European debt crisis seemingly of little concern to investors. Politicians seem content kicking the fabled can down the road. Given an arm-chair ride by markets, necessity – a precursor to change – is lacking.

New Zealand experienced this cycle for more than a decade prior to 1984. By 1984, necessity was recognised – with crisis upon the economy.

Two nations are key to watch in 2013, namely Italy (more economic relevance than Spain in Europe) and the USA. To highlight the fiscal challenges, let's look at the average primary balance that would be required to get net debt down to a "sustainable" position in ten years. For argument's sake we define "sustainable" as the lower of 60 percent of GDP. And we look at different combinations of growth and real interest rates as both are important components of the fiscal sustainability story.

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Italy faces an uphill battle. Italy has a primary surplus – a huge plus, but a very large stock of debt. The economy recorded an average growth rate of 1.7 percent in the decade prior to the GFC. Even if they were to manage average growth of 2 percent over the next 10 years (which would out-do recent history, when they were busily borrowing) at real interest rates north of 3 percent, some pretty hefty primary surpluses are required. All this with a rapidly ageing population? The maths is not pretty.

ITALY
Average primary balance required over next decade for sustainable net debt

REAL 10 YR YIELDS	REAL GDP GROWTH				
	0.00	1.00	2.00	3.00	4.00
5.00	7.9	7.1	6.2	5.4	4.6
4.00	7.1	6.2	5.4	4.6	3.8
3.00	6.2	5.4	4.6	3.8	3.0
2.00	5.4	4.6	3.8	3.0	2.2
1.00	4.6	3.8	3.0	2.2	1.4
0.00	3.8	3.0	2.2	1.4	0.6

% of GDP: Primary balance 2012: +1.9%
Net Govt debt 2012: 98.1%
Sources: ANZ, OECD

The numbers for the US are not as ugly in terms of the primary surplus needed, but require an overhaul of fiscal policy. The USA has a lower debt profile than Italy, but has a large primary deficit and it is the rapid change (lifts) in debt from year to year that is worrying. At growth of say 2 percent, the government needs to run a roughly balanced budget to return net debt to a more sustainable level over the next decade. But a caveat – this analysis gives the average primary budget balance required over the next ten years. The US primary deficit was 7 percent of GDP in 2012. This is a very slow ship to turn and flipping this into a primary surplus is a huge lurch in policy settings. In practice, achieving primary balance over the next 10 years will require some very large surpluses in the second half of the decade.

US
Average primary balance required over next decade for sustainable net debt

REAL 10 YR YIELDS	REAL GDP GROWTH				
	0.00	1.00	2.00	3.00	4.00
5.00	6.4	5.7	4.9	4.1	3.4
4.00	5.7	4.9	4.1	3.4	2.6
3.00	4.9	4.1	3.4	2.6	1.9
2.00	4.1	3.4	2.6	1.9	1.1
1.00	3.4	2.6	1.9	1.1	0.4
0.00	2.6	1.9	1.1	0.4	-0.3

% of GDP: Primary balance 2012: -6.7%
Net Govt debt 2012: 86.5%
Sources: ANZ, OECD

If, for example, we use the OECD forecast of net US debt of 86.5 percent of GDP in 2012, and not unrealistically assume the US will take until 2017 to stop adding to its net debt, they would need a whopping primary surplus 3.8 percent of GDP the following five years to hit the 60 percent net debt target by 2022. That's a massive change in fiscal policy settings.

Do we foresee a circuit breaker in 2013 that breaks the spiral? There are candidates, but they face challenges. Options include: strong growth (which seems unlikely given deleveraging requirements, a lack of reform and lags between reform and growth anyway); a consensus across Western society for change and reform (think of turkeys voting for an early Christmas); political consensus both at the intra-country level and across nations within the likes of Europe and between the USA and China (game theory tells us otherwise). Debt relief / write-offs for peripheral Europe to reset the clock look inevitable but are a low-odds bet at the current point in time. Inflation surprises could be one of the few variables to assist countries in deflating their debt by stealth, though Japan has been trying this for decades: deleveraging is deflationary as opposed to inflationary. And so we're left with the monetary printing presses pumping up asset values in the hope that we'll generate sufficient growth to magically erode the debt burden.

For New Zealand, the circle of "[dis]trust" is relevant on a number of levels.

First, we're the two-bit player at the international roulette table. **If global markets are set to swing and oscillate through the circle of [dis]trust over 2013 then New Zealand will be caught in the rip.** This means global nuances will dominate local ones once again, so we're set for another year

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of volatility. We expect the NZD to remain elevated relative to nations of fair value and oscillate from being extremely expensive to expensive (think 0.76-0.86 cents) depending on the stage in the [dis]trust cycle.

Second, New Zealand's fundamentals remain weak in some areas and the potential for contagion risks from offshore will need to be managed. New Zealand's national balance sheet remains structurally impaired **though it has improved markedly over the past three years.** Net external debt has fallen from 85 to 71 percent of GDP. The household savings rate has improved from -3.3 percent of disposable income in 2009 to a zero balance in 2012 (and from -8 percent in 2003). That's progress from dreadful to bad. **Households have deleveraged somewhat, though are showing signs of pre-2007 behaviour.** Household debt to income has fallen from a peak of 154 percent in mid-2008 to 143 percent in September last year.

The fiscal position has deteriorated markedly, though with net debt still below 30 percent of GDP (the OECD average is 65 percent) it's still world class.

Weak fundamentals up the ante on defining, articulating and generating sufficient buy-in (i.e. a consensus) to execute a growth agenda. New Zealand needs to be squeaky clean, which ties in to Theme 2, transitioning via differentiation.

Third, New Zealand is managing to break the spiral at the local level, which mitigates the contagion risks. This is happening on a number of levels and we need to see more of the same.

- **There is more fiscal leadership than populism;** the polar opposite to what's happening in other nations.
- **The banking sector remains strong, with substantial new prudential oversight mechanisms also introduced over the past three years.**
- **Reform is occurring,** despite some angst in certain areas (i.e. asset sales). Society still looks modestly **receptive to change** and is broadly buying into the government's strategy of reform and more efficient use of public services. It's not universal, but policymaking never is. The main opposing political party is promoting a capital gains tax and raising the retirement age, so the reform agenda is not the sole domain of the incumbents. Neither the mainstream political parties will admit it but there is some pretty strong commonality in key policy areas. The past year has seen initiatives in welfare, local government, state-owned assets ownership, and continued implementation of earlier tax policy initiatives. These are not game-changers, but the combination adds more steel to the economy's backbone.
- **Economic growth prospects are being supported** by the Christchurch rebuild, boosting construction and employment at a time when the government is tightening its own belt as it plans to return to surplus. Having a city rebuild ahead is somewhat fortuitous for the New Zealand economy. It's growth in the bag, and if there is one variable to eye over the coming year, it's growth: debt positions can quickly turn pear-shape when growth is absent.

THEME 2: TRANSITIONING VIA DIFFERENTIATION – FOUR UNHERALDED LEGS OF THE GROWTH STORY

The upshot: The New Zealand economy – like a host of others, continues to transition, facing a slow growth trajectory amidst a process of balance sheet repair and alterations in the mix to growth. Beyond conventional price signals and drivers of growth across the New Zealand economy, four less-often cited factors will be critical in this transition: unlocking more growth from areas of advantage, including an abundance of natural resources; wrapping an innovation strategy around New Zealand's unique points of comparative advantage; a functional political system; and society remaining receptive to change. On top of this the microeconomic reform agenda needs to keep being progressed. These are modern day differentiators that go beyond the conventional wisdom as to what drives growth, and growth is key for economic transitions to take place in an orderly fashion.

For the past couple of years we've identified **a five-staged process for the New Zealand economy, and they still apply.**

The first stage (A) was the "old normal", where credit growth exceeded incomes by a factor of 2 or 3, traditional risk-return identities were ignored, growth became lopsided, imbalances ballooned, asset price bubbles materialised and artificial wealth drove spending. Ironically, the 1990s-2007 period was also referred to as the "Great Moderation" in recognition of a period of relative economic stability. **Stage B (over 2008-09) saw the inevitable initial purging** that follows such excesses. The "Great Moderation" was nothing of the sort; spending beyond one's means turned out to be unsustainable, surprise, surprise. **Stage C** was the healing or recovery process that we saw in late 2009 and the first six months of 2010, helped by aggressive

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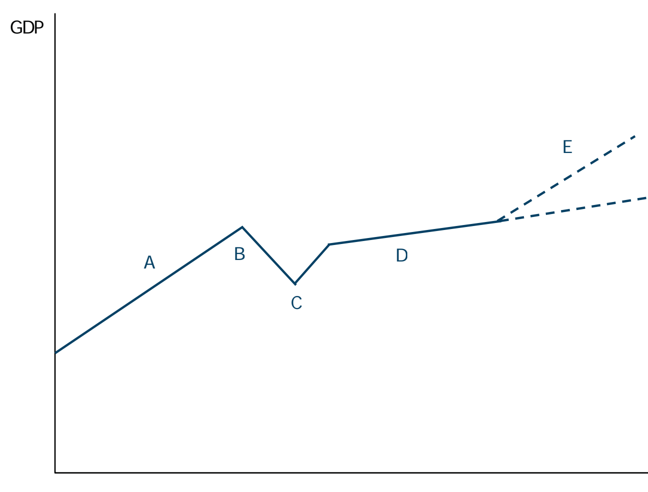
policy action and an inventory rebuild. "Healing" or "recovery" is probably a bit optimistic: it's more like **stabilisation** following capitulation, and a recoil off lows.

The New Zealand (and global) economy entered stage D – which we call "transition", around the middle of 2010. Normal pro-cyclical forces and drivers of the business cycle, such as consumer spending, failed to kick on and take the inventory rebuild into something of substance. That's because there's a debt "supercycle" and payback dynamic that is overwhelming the usual cyclical forces. This period is where the economy transitions on a number of levels, including **altering the mix of growth (rebalancing)** and also paying penance for prior sins, i.e. **lowering debt** as a share of GDP across Western society. This stage entails **a period of stuttering and "grumpy" growth (D)** as stylised below. You need to get enough growth during stage D to progress and remain master of your own destiny: a stagnant economy risks losing investor confidence and also creates social time-bombs down the track. However, the risk is that if you get too much growth, or things become easy, complacency sets in. You can see this dynamic across some industries with the meat sector a prime example: strong lamb prices in late 2011 deflected attention away from inevitable consolidation and hard choices, which are now coming back onto the agenda.

In the **final stage (E), trend growth rates (the slope) will be at least partly a reflection of the choices made in the transition stage. There is also a time limit on the transition stage determined by pending demographic pressure.** New Zealand's demographics are altering. By 2020 there will be around 4 persons aged 15-64 for each person aged over 65, down from 5.9 in 1990. People are living longer. It is blatantly obvious the current system is unaffordable. Changes will be required. The degree of change can be minimised by progress made in the transition stage (speed and quality) to unlock stronger growth potential during stage E.



The economy has been in the transition stage for a couple of years already and will remain so for a number of years to come. We are not talking booms to busts (we hope), but rather a period of sustained grumpy growth: there will be growth, but not at the pre-GFC rates we became accustomed to, and we'll be working a lot harder to get it. Transition will involve a number of dynamics:

- **A capped rate of growth,** as a leveraging (borrowing) tailwind is replaced by a deleveraging headwind. The slope of D is less than A. For New Zealand we believe this trend rate is somewhere around 2 percent in terms of real GDP growth.
- **A different mix to growth.** It is untenable to imagine a debt-laden nation borrowing and spending its way out of a debt-induced jam. So spending sides of the economy need to underperform. However, this thematic is being tested with the requirement to rebuild New Zealand's second-largest city and a less than ideal mix to monetary conditions across the economy **(refer Theme 4)**.
- **The re-mobilisation of resources,** including labour and capital across sectors, as a spend-centric model is replaced by a more balanced model for growth. Capital and labour does not respond instantaneously. It will be messy. Getting the basics right, such as a well-functioning education system that responds to signals from the private sector will be key. This turns attention away from the macroeconomic picture and towards the microeconomic agenda. The length of the journey in D or period of grumpy growth can be shortened by getting resources shifting and responding in a timely manner. On some levels we can see price signals working (i.e. real wages falling in some industries) and economic incentives

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tilting behaviour. On others (i.e. an inflated NZD beyond local fundamentals), we're not. Hence, it's a journey fraught with frictions.

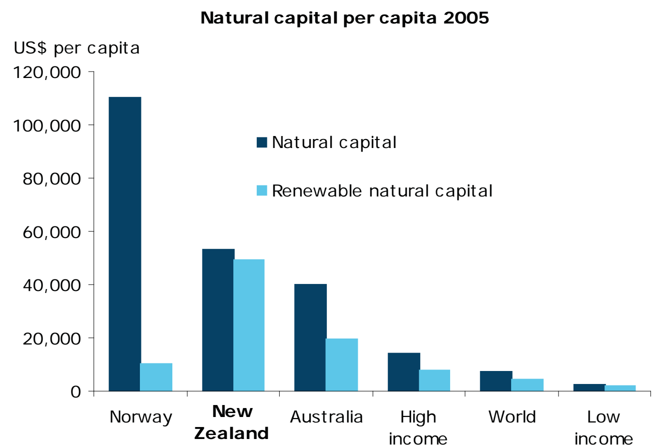
So what determines the rate of growth in the transition stage? **The weaker the balance sheet, the greater the deleveraging headwind** holding back near-term growth. New Zealand is somewhat saddled here by sins of its past. Flexibility across the economy in areas such as the labour market and having a floating currency all assist by allowing price signals and resources to adjust more readily. On this front, New Zealand stands strong. Those with limited flexibility and poor price signals stand ready to repeat New Zealand's experience of the 1980s – zero growth over six years, clearly a dire outcome. But even for those countries, the resulting performance will probably be better than the alternative of doing nothing.

Economists can probably point to 80-odd factors that determine growth. The problem is that it's difficult to disentangle the causality, as many of the so-called growth-determinants (such as investment) are key components of GDP themselves. We know that traditional dynamics such as population and productivity will of course be influential.

However, **there is also a strong behavioural aspect that operates and drives an economy,** particularly when you are witnessing a fundamental change in the DNA of society, and you need the confidence of investors. **Living standards are simply not what we had convinced ourselves they were,** and we can either drop them immediately or wait (hope) and strive for income-generating capacity to catch up. And while this goes on, we need to be cognisant of the economic environment: it's all about maintaining confidence, credibility and showing competence as such changes are taking place. Nothing is a problem until markets think it is a problem. **As Ireland, Greece, Italy and other highly indebted countries will bear witness, problems can turn exponentially ugly in a very short space of time.**

Key for a transitioning nation is the concept of differentiation and convincing investors that you're on the right track. Investors are eyeing the scene with confusion, and New Zealand is facing a marketing challenge of the utmost importance. There are the conventional insights that offer Asia up as delivering nirvana. There is a lot of upside here, though we believe New Zealand's story is far deeper in terms of the factors we need to be eyeing.

New Zealand needs to up the ante on unlocking our natural endowment riches. It is easier to transition if you have strategic areas of excellence, or areas of comparative advantage, and particularly if they are complementary to structural shifts around the globe. This makes it possible to get debt to GDP down by lifting economic growth, a far preferable adjustment path to scrimping. Structural reform agendas are easier to pursue if your endowment is high, because the economic payback is quicker via avenues such as unemployment (which matters in a political sense). It is far more difficult to implement reform if the perceived payback is slow (which is one reason reform tends to be a consequence of a big-bang ex-post "accident" as opposed to being proactive). New Zealand has a lot to point to here: water and land (alongside Mother Nature) clearly top the list, but energy, natural beauty (tourism), a huge economic exclusive zone, the brand NZ.Inc, food safety, minerals, and potentially oil also feature … the list goes on. A host of these are complementary to structural changes around the globe, such as more consumption-centric growth in Asia and stronger demand for protein and fat.



Source: The World Bank "The Changing Wealth of Nations" 2010

NZ ranks 8th in the per capita natural resource wealth stakes globally, a few notches higher than Australia, who are often deemed the lucky country. The only countries ranking higher export huge amounts of oil. And **in terms of renewable natural capital** (think land, timber, heritage assets, a large economic exclusive zone), **New Zealand leads the world on a per capita basis.** Thinking about this in terms of the nations in Asia that we have free-trade agreements with – those very nations that are growing consumption at a fast clip and are "short" natural resources (refer table on page 15) – and you can understand offshore investment interest in New Zealand agriculture as a secular theme. It's not going away anytime soon. This is leading to various gestation issues in some camps over foreign ownership. It goes without saying that you need an appropriate regulatory framework to mitigate

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exploitation risks. New Zealand's regime by global standards is stringent. The OECD ranks NZ as the 7th most restrictive of 55 developed economies in terms of foreign investment regimes.

There are also tensions between some of these endowments. Unlocking them is not easy. You wouldn't want one area of strategic excellence such as mining to undermine another such as tourism, so sensible regulatory heads are required. **Moreover, having a large natural endowment does not guarantee success for a nation.** Indeed, it has historically tended to invite corruption and foreign exploitation.

Just like **successful businesses need something in their offering that is "different"** (whether that be brand, relationships, or a better service proposition), **the same applies for a nation.** New Zealand has this in spades, and it's critical, **for the more you pull an income-generating lever, the less pressure there is for austerity.** This makes issues such as the current debate over water rights (allocation, treaty, ownership) key to watch as somewhat of a flagbearer for New Zealand's prospects. We'll turn very bearish if a key part of New Zealand's flagged endowment riches gets bogged down and stymied by legal dysentery. The same applies for the likes of our economic exclusive zone.

New Zealand's huge natural endowment or areas of comparative advantage will not deliver economic nirvana alone. It's akin to a rugby team with deep in natural talent that doesn't necessarily perform on the field, and there are some good local examples of that!

For riches to be unlocked, there are a host of issues that need to be addressed and fast-tracked. The right infrastructure needs to be in place, broadband functioning (think global connectivity), scientific method promoted, property rights defined, and the correct incentives to work and invest set in place etc. **There seems to be enough happening here to keep offering hope, though it seems to be somewhat of a two-steps forward and one-step back process.**

However, we also need to wrap an innovation strategy around our natural areas of comparative advantage. New Zealand will not get rich shunting out volumes of agriculture produce like it's been doing for the past 30 years. To change and embrace such a strategy we suspect more thinking outside the "square" is required. Consider the following examples:

- It rains here, so we have good access to water which can boost primary production if storage capability can be developed. This is key for areas such as Canterbury, Hawke's Bay and Wairarapa. We should also be experts in regard to irrigation, water treatment, pumps, pipes and everything hydro.
- We pride ourselves on being clean and green so we should be leaders in green technology, renewable energy, insulation and eco-friendly homes.
- Our primary industries are world class so we should be exploiting these and diversifying away from farm-gate and production mantras to creating and marketing associated technologies, animal husbandry products, genetics, aquaculture, fisheries management and pest control.
- We are a sports-mad nation punching above our weight on a population basis at the Olympics. This makes us a prime candidate as a nursery for training coaches and sports development.
- We've a city rebuild to contend with. God forbid another city suffers the same fate, although the odds are that one will. When that happens, New Zealand should be leading the pack and be the first port of call on building design and all engineering facets of rebuilding a city.

The crux here is to get people thinking beyond the obvious and into identifying and positioning a wider value-added proposition.

The political framework needs to be, and is, functional. New Zealanders tend to take their lack of corruption and well-functioning political system as a given. But it matters. And while "democracy is the worst form of Government except all those other forms that have been tried from time to time" in that it rewards short-term thinking, we are encouraged by the consistency being shown across the entire political spectrum towards fiscal savings and responsibility. Moreover, New Zealand has a political framework that is reasonably adaptive and receptive to change in a relative sense. Of course, MMP has presented its own challenges. If you want evidence of political fragmentation and institutions that are conducive to gridlock, look no further than the US and Europe. Our system is not perfect, but it's far better than most.

Society needs to remain receptive to change. An economy is a super-tanker: it takes time to turn. Leadership can only take you so far – habits have to change on the ground. Our economic performance, after all, reflects the decisions of 4+ million individuals, whether that's their borrowing, spending, or voting decisions. Japan's lost decade epitomises a

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refusal to bite the bullet. It appears that the critical mass in New Zealand is now tilting towards necessary structural change. Witness the continued uptake of KiwiSaver despite the smaller carrots now on offer; the focus on fiscal responsibility in the 2011 election; a refreshingly non-hysterical discussion of the possibility of raising the retirement age beyond the age of 65; and the savings debate turning more towards compulsion.

Such signals don't guarantee that society is willing to do the hard yards, but its reassuring that things are moving in the right direction. However, we're also seeing evidence of old style behaviour and the belief that house prices only go up, though it is not flowing into the broader economy and measures such as consumer confidence. There appears to be a lack of clear "consensus" in some sensitive areas (asset sales and water being two) which polarises the political arena and stymies progress. Ultimately we believe such tensions will be overcome, but we'll be tracking such debates with interest as fundamental flagbearers for New Zealand's future prospects.

We need to continue the process of microeconomic reform. Microeconomic issues are often overlooked when assessing the macroeconomy, but as stated, the economy is the summation of its parts. It is crucial to get the right incentives in place. New Zealand has already done a lot of the heavy lifting in terms of getting a system that is world class. We rank at the upper end of the OECD in terms of literacy, attainment of secondary and tertiary education, transparency of our institutions, and law and order. Access to childcare has vastly improved, half of the population has now enrolled in Kiwisaver, and reform of the RMA has helped address infrastructure bottlenecks. However, we've got some clear challenges in key socio-economic groupings too.

Incremental improvements can still be made to overcome the tyranny of distance from markets. Tax policy is a biggie here (we'd raise GST, bring in a capital gains tax and cut income tax rates further), as well as welfare policy design, the ease of starting a business, property rights, balancing public and private interests, and avoiding corruption and rent-seeking behaviour (moulding one's economic activity around maximising returns from distortionary policies, rather than true economic profit).

These factors do not deliver nirvana. Nothing does. They also come with complications. Investor confidence and belief in the wider New Zealand economic story is one factor inflating the currency beyond levels dictated by local fundamentals today. In short, investors are banking on the story being delivered. The challenge for New Zealand is to deliver in the face of an elevated currency. Amongst the hurly burly of what to do about the currency (intervene, cut interest rates, capital controls) only one idea has any credence: an obsession with lifting competitiveness, and this will require give and take across all levels of the economy from central government, local government to businesses, farmers, and unions. At present, constituents from each of these groups appear to be in a round room looking for four corners.

In a world that is "transitioning", differentiation through showing competency and maintaining confidence is key. **Such differentiation allows you to remain in control of your own destiny (and adjustment).** The alternative is Greece.

THEME 3: SOVEREIGN RISK

The upshot: Our sovereign risk analysis – which encapsulates negative (i.e. debt) and positive attributes (i.e. flexibility) across 38 countries remains European-centric at the problem end. France and Italy will be key to watch over the coming year. Nations such as the USA continue to buy time (courtesy of greater economic flexibility), though we view the clock as ticking. Interest rates will need to remain low and anchored for fiscal sustainability issues to be addressed, but the critical component will be economic reform driving growth. This is the missing ingredient.

What a relief! After months of political wrangling and overt displays of brinkmanship on both sides, **US politicians announced an eleventh-hour deal, averting the so-called "fiscal cliff". But was it really a relief; and did the "deal" have any substance? Most serious commentators thought not,** and some, including *The Economist*, called the deal "lousy". Indeed, they were scathing of it, noting that the final deal raised less tax than the Republicans had offered during negotiations, and lacked some of the spending cuts President Obama was once prepared to offer. But worst of all, The Economist said, it made the United States look like Europe, who have become masters of the can-kicking quick-fix. **This is how 2013 began, and we believe this is also how 2013 will unfold: with fiscal tensions front and centre.**

To be fair, a host of the fiscal "issues" have arisen from the nationalisation or socialisation of private sector problems at the root of the 2008 crisis. **Absorbing debt onto government balance sheets has merely bought time.** To some degree, markets have gotten used to the fiscal environment that developed countries now find themselves in. Bond markets have become used to eleventh-hour

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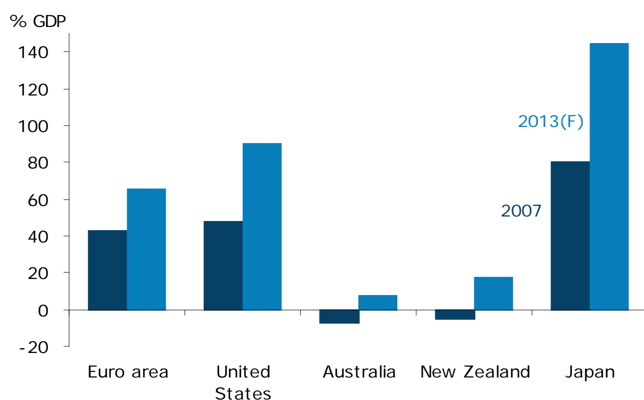
deals, and now trade, some would argue quite legitimately, as if there is not a proverbial ambulance at the bottom of the cliff, but rather as if some scheme will be concocted to prevent anyone going over the cliff. Thus far, it has worked. Politicians in Europe have shown themselves to be adept at coming up with cunning plan after cunning plan, and full-blown crises have been averted (see Theme 1, the cycle of [dis]trust rolls on), even if on occasion investors were left on the edge of their seats waiting for announcements. **However, behind the scenes, serious sustainability issues remain.**

We first recognised that all was not well in peripheral markets in 2010 and went looking for the next potential hot-spot. Markets have been on a rollercoaster ride since then, with yields in some parts of the periphery trading well into double-digits in 2011, before normalising somewhat in the past year or so. Yet **Europe's debt pile has never been bigger, and nor has America's. But perhaps the biggest problem has been (and will be) the lack of growth,** for it is the nominal growth rate, along with the cost of financing the debt (i.e. the bond yield) that matters insofar as debt sustainability is concerned.

Addressing **solvency concerns offers a Clayton's choice in terms of solutions.** Doing nothing makes the situation worse and eventually market forces demand a premium, taking yields higher. Necessary fiscal retrenchment to restore confidence detracts from demand which makes the debt burden worse in the near-term. Such retrenchment reduces your fiscal flexibility. This, in turn, puts more pressure on monetary policy as a stabiliser and risks undermining its independence. Society is not often receptive to reform, which is required to lift growth.



Sources: ANZ, OECD (Note: superannuation funds treated as assets for NZ and Australia, hence net debt below official government statistics)

And so the debt pile keeps growing. As an example, Euro area net debt has risen from 42.7 percent of GDP in 2007 to a forecast 65.3 percent of GDP this year; over the same period, US net debt to GDP has increased from 48.0 percent to 90.1 percent of GDP. Japan's net debt is a whopping 144 percent of GDP, though this is more than offset by private sector savings.

Regular readers will recall that **we developed an indicator almost four years ago to assess sovereign debt vulnerability in an objective manner,** and this research builds on earlier work. Indeed, sovereign risk has been one of our key themes at the start of each year since 2010. From the outset we acknowledged, and still do, **that we do not have the resources of a credit rating agency. However, we do have access to plenty of data, enabling us to assess a host of countries on the basis of two broad criteria. First, we look at "bad" or "worry" variables** – things like government debt, the fiscal balance, the current account, net external debt and the unemployment rate. Including variables beyond fiscal metrics such as the current account and external position means t**he term "sovereign risk" really personifies the risk of the nation as a whole, as opposed to merely the government in isolation.**

We also recognised that there would be offsets, and looked at things like GDP per capita, population growth, the existence of a floating exchange rate, political stability, competitiveness etc. **These variables are critical as they signify a degree of flexibility within the economic system: this flexibility can buy you a lot of time to work through issues.** Another way to think about this is in simple business parlance. A business with a lot of debt may be struggling, but the *coup-de-grâce* is ultimately delivered when the revenue line tips over. The same applies for a nation. The metric here is GDP. The death spiral beckons when debt is rising and GDP is contracting. By comparing one set of criteria against the other, we arrived at a "net" score giving a simple metric of sovereign vulnerability.

To recap on our methodology, we collect comparable statistics across 38 countries, comprising the OECD and the major Asian economies. Where possible, we collect data from the same source for consistency. Negative unfavourable scores are added to positive favourable scores to arrive at an overall vulnerability score, with the most vulnerable countries having the lowest (generally negative) overall scores.

As we noted, the two sub-scores, and how they fare are important. Having a good favourable score doesn't eliminate challenges but they do buy you time to work issues out. Witness the US losing its AAA status in 2011.

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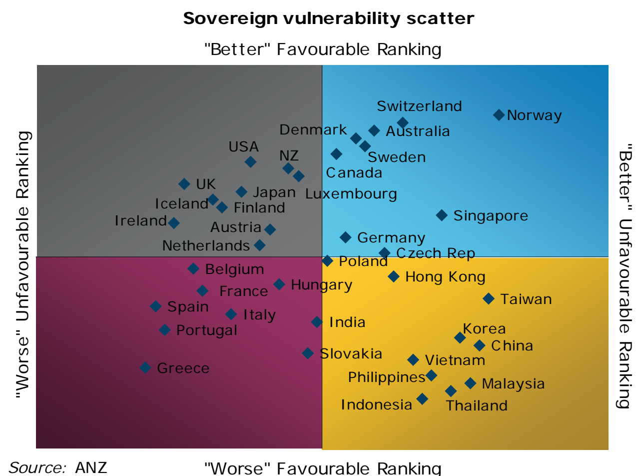
The table below and scatter plot to the right summarise the results. **Nations are ranked according to the overall score, which is the net of the unfavourable and favourable numbers.** But remember, this is a peer group comparison, so it is how you measure up to the competition that matters. Because investors have a choice as to where they invest, what matters most is a country's overall placing on the table.

Overall Rank	Country	Overall Score	S&P Credit Rating
1	Norway	47%	AAA
2	Switzerland	25%	AAA
3	Australia	18%	AAA
4	Denmark	12%	AAA
5	Sweden	12%	AAA
6	Singapore	12%	AAA
7	Canada	9%	AAA
8	Taiwan	8%	AA-
9	NZ	5%	AA
10	Luxembourg	4%	AAA
11	USA	1%	AA+
12	Korea	-3%	A+
13	Japan	-3%	AA-
14	Czech Rep	-3%	AA-
15	Hong Kong	-5%	AAA
16	Germany	-5%	AAA
17	China	-6%	AA-
18	Poland	-10%	A-
19	Austria	-11%	AA+
20	Iceland	-12%	BBB-
21	Finland	-12%	AAA
22	Netherlands	-12%	AAA
23	UK	-15%	AAA
24	Malaysia	-15%	A-
25	Hungary	-16%	BB
26	Philippines	-17%	BB+
27	India	-18%	BBB-
28	Vietnam	-19%	BB-
29	Thailand	-19%	BBB+
30	Belgium	-24%	AA
31	Indonesia	-25%	BB+
32	Italy	-25%	BBB+
33	Slovakia	-26%	A+
34	France	-27%	AA+
35	Ireland	-28%	BBB+
36	Spain	-41%	BBB-
37	Portugal	-42%	BB
38	Greece	-66%	SD

Sovereign vulnerability scatter



Source: ANZ

Our analysis highlights **several points, many of which have been consistent** in our past rankings:

- **Europe continues to dominate the bottom of the table.** What's more, the bottom left or "storm warning ahead" quadrant of our scatter plot of favourable and unfavourable rankings is dominated by Europe, highlighting that the area will remain a key battleground in years to come despite conditions stabilising of late.
- **Euro-heavyweights France and Italy are among the bottom seven.** For a long time, the focus has been on minnows like Greece. Its problems are not trivial, but they are manageable in a global context. By contrast, France and Italy (the 5th and 8th largest economies in the world) are economic giants with €3.8 trillion of government debt between them.
- **The countries that made the top seven rankings have not changed,** and are dominated by Scandinavia, Switzerland, Singapore and the commodity countries (excluding New Zealand). These countries all sit in the top right or "becalmed" quadrant of our scatter plot.
- The only G7 country in the top ten is Canada. **By and large, the major countries were notable for how poorly their "unfavourable" scores were, but all got a reprieving "offset" thanks to being large, rich and flexible.** This put them in the top left or "choppy waters" quadrant of our scatter plot. For these countries, there are problems on the debt and economic front, but size, wealth, good governance and a floating exchange rate gives them time to work through their problems. **New Zealand falls just within this quadrant too.** It doesn't have much Government debt, but earthquake-induced budget deficits, a large net external debt position, and our current account deficit let us down.

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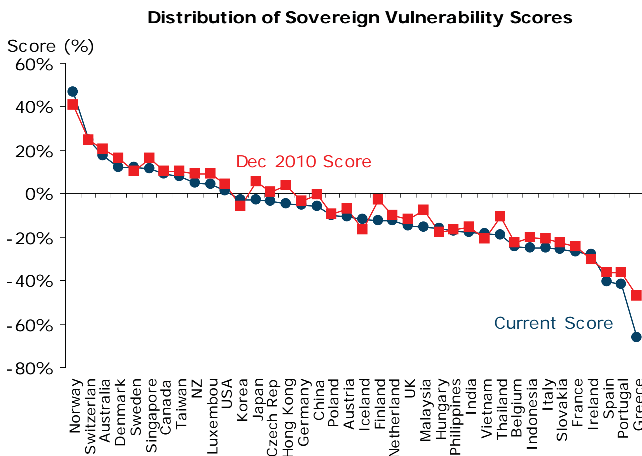
- **The United States' ranking improved, but this was thanks largely to a *forecast* improvement in the government deficit.** The OECD forecasts improvements for most countries, as do the rating agencies. But the key is delivering on these. If they don't, another US downgrade seems inevitable at some point. The last downgrade didn't have much of an impact on yields (they actually fell as investors flocked to the "safe haven" of US Treasury bonds!). But it was the indirect consequence – massive diversification inflows into our bond markets – that mattered for Australia and New Zealand. These flows not only put a rocket under the NZD, but they also pushed term rates lower, which had a knock-on effect to mortgage rates and the housing market.

It is also worth noting the one thing that has changed significantly is **the overall distribution of scores. Two years ago, the scores ranged from -47 percent to +41 percent. Today they range from -66 percent to +47 percent** (using the same methodology). **The bad are getting worse, the good are getting better.**



Source: ANZ

There are three basic facets to a sovereign debt crisis from a sustainability perspective. **The first is the amount of debt, the second is the interest rate payable on that debt, and the third is growth.**

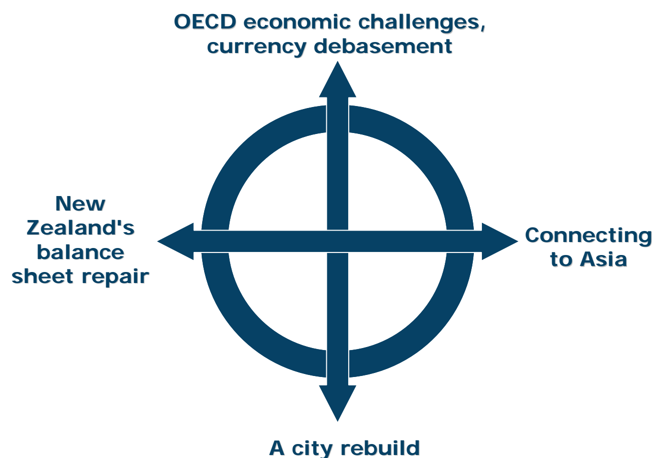
Because there is not much that can be done quickly to reduce debt (particularly without growth), this leaves the focus on the other two facets. At the moment, yields are low – even in the European periphery (recall that Mediterranean yields were routinely in double digits pre-euro). And even if one takes a dim view of the can-kicking responses to date, they have been effective in containing yields. But all such cunning plans do is buy time – without proper reform, the problems will persist and slowly get worse. Markets are certainly very sanguine on sovereign credit risk in general. In short, **yields are about as depressed as they are likely to be for the majors (thanks to QE), and for the profligates (thanks to can-kicking).**

Austerity and credible fiscal policy is a necessary but far from sufficient condition for debt sustainability. The key ingredient is growth. **The lack of it in some profligate nations is likely to be a key focal point in 2013.**

THEME 4: A POLARISED COMPASS

The upshot: New Zealand's economic compass is being dominated by four facets: restoring semblances of health to the national balance sheet (including restrictive fiscal policy); the OECD's economic challenges (and associated currency debasement which inflates the NZD beyond local fundamentals); upside that connecting to Asia is bringing (including robust soft commodity prices); and rebuilding a city. Some facets are complementary, others are opposing, leading to dispersion and variability across economic indicators. They will remain relevant for a considerable period. New Zealand will lurch from bearing to bearing (i.e. from shock to shock), but one shock alone will not dominate which means financial market variables will oscillate as opposed to trend. A polarised compass means greater performance variability across and within industries with the gap between good and poor businesses widening.

New Zealand's economic compass remains polarised as we lurch from strategic imperative to strategic imperative and these are also interacting with traditional cyclical drivers of the economic cycle.



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At one extreme **the economy remains notoriously unbalanced** with a lopsided focus on the non-tradable, rather than tradable sector, **and a weak national balance sheet.** The next leg of the deleveraging process is restrictive fiscal policy. Restoring a modicum of health to the national balance sheet is a prerequisite to any sort of cyclical upturn taking hold. Facing deleveraging and rebalancing imperatives we talk of a soup-bowl (U) or bathtub recovery prevailing over the martini glass (V).

The global scene remains wobbly across the OECD, and economic challenges are becoming a major "export" for some nations. Currency debasement is inflating the NZD beyond local fundamentals, while an uncertain global scene keeps interest rates low. We may like the latter – and the Auckland property market certainly does – but the combination is a mix to monetary conditions completely at odds with what balance sheet requirements dictate. **Currencies such as the NZD/USD trading out of line with domestic fundamentals is common and given it is likely to continue, such divergence must be matched by interest rate convergence.** This argues for lower rates – as Australia is finding.

A positive income shock continues to manifest. Asia continues to grow quickly, despite challenges across a host of Western economies. Asia remains "coupled" to the OECD, but is generating more internal demand. We are seeing structurally higher demand for soft commodities as incomes rise. Asia is increasingly relevant for New Zealand as an export market, with Asia ex-Japan now accounting for more than a third of our merchandise exports, versus less than a quarter a decade ago. Asia is supporting Australia, New Zealand's largest trading partner. China is also now New Zealand's second-largest source of tourists. We're getting better connected to Asia via free-trade agreements. But we must add a note of caution here: with exposure to the upside of Asia's potential comes increased vulnerability to adverse turns – both via Asia and indirectly via Australia.

We need to rebuild our second-largest city. The impact channels are endless. Relative to the size of the economy, the estimated cost (more than 10 percent of GDP) is unrivalled globally. Christchurch is a critical hub for the South Island, and an important component of the wider NZ.Inc story. The construction response is pending and is due to peak in 2016, but will still add to economic activity for many years thereafter. Christchurch's events have altered building and insurance standards nationally (and costs). We need to rebuild a lot of destroyed domestic capital at a time resources need to be deployed to tradable-centric areas. The rebuild risks blowing out the current account deficit unless consumption spending drops as a share of GDP. Over time the costs of rebuilding Christchurch will hit consumers' and farmers pockets via increased levies, higher building costs and insurance premiums and reduced government spending in other areas.

These shocks are complementary in some facets but opposing in others. Deleveraging is deflationary. Positive commodity income shocks and natural disasters are not (indeed, we'd put some of the current Auckland housing inflation down to earthquake-related migration). The income shock is helping New Zealand get its balance sheet back in order, particularly in the rural sector via income generation (a higher denominator helps lower debt and deficit-to-income metrics). Conversely, rebuilding Christchurch will involve dedicating resources to rebuilding domestic capital (i.e. housing and infrastructure) at a time when we're also supposed to be investing in other regions and sectors to address our national indebtedness and imbalances. We're already seeing the consequences of these shocks interacting in variables such as the CPI and wages. Structural forces colliding means more dispersion across such measures.

To put these shocks in perspective in terms of their significance, an issue such as the "Leaky Homes" crisis, which hasn't gone away and is hugely relevant, doesn't make the cut. And if we were ranking economic developments by national significance, Psa – which is decimating the kiwifruit industry – would not even make the top ten. This is not to belittle the kiwifruit industry or those facing large building repair bills. It merely underlines **the mammoth scale of the forces buffeting the New Zealand economy at present.**

Markets tend to lurch around as focus shifts from one theme to the other. Given the opposing nature of many of the shocks hitting the economy, we continue to expect a period of heightened volatility in financial variables as markets switch between different themes. Christchurch is telling the RBNZ to hike rates. A high NZD and contained CPI says the reverse. Market pricing will see-saw over the year. Various themes will dominate individually from month to month, which will make an underlying assessment of the true state of affairs difficult. Just because a theme is not dominating the data-flow over three months doesn't mean it has become irrelevant.

We suspect New Zealand will be drawn to all four corners of the compass in 2013. Households still need to get balance sheets on a stronger footing

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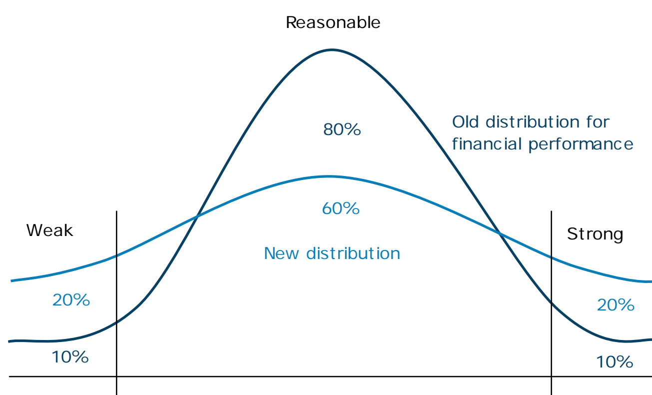
and tighter fiscal settings will sap spending power out of the economy. The outlook for retailing will remain tough. OECD wobbles will reappear (refer Themes 1 and 3). Ironically, this will exacerbate a likely wrong mix to monetary conditions (i.e. continued low interest rates and a high currency). The outlook for Asia and soft commodity prices looks buoyant for 2013. The rebuild is cranking up. Of course we have cyclical drivers of the economy to monitor too: interest rates are low and the housing market is responding.

Some may ask **why is housing (shortages or renewed enthusiasm) not included as a bearing on the compass?** There are **three reasons.** First, we think the microeconomic evidence still points to a structural change in consumer behaviour. Second, we expect balance sheet considerations to dominate supply-demand dynamics with the latter concentrated in only one region. Third, if the housing market and borrowing keeps lifting in a cyclical sense, one or more of three things will happen. The OCR will rise. New Zealand will receive a credit downgrade. The RBNZ will likely lean more heavily on prudential policy. Such forces will not alleviate supply-demand imbalances in the likes of Auckland which require a broader policy response. However, they **will temper the potential for housing to turn into an enduring theme, and it is the enduring themes we are more focused upon.**

Offsetting shocks means conflicting economic signals and mixed messages for businesses. The historical "distribution" in terms of business performance within every sector has tended to be around **10-80-10**. Ten percent are incredibly strong performers. Eighty percent perform okay, ranging from muddling through to being solid. Ten percent are constantly churned – the perennial underperformers.

The changing distribution of financial performance



This distribution is evolving more towards **20-60-20**. Twenty percent of businesses are strong. Sixty percent are muddling through or solid. Twenty percent risk being churned. Why the change? **Structural changes at the economy wide level also necessitate change at the core business level if firms are going to survive, let along thrive.** Microeconomic foundations need to be strengthened, with continued emphasis on doing the basics well, but also greater willingness to adapt to suit the changing environment. Firms need to get more strategic with their future direction and highlight themselves in a positive light rather than just muddle through. "She'll be right" no longer applies in an increasingly connected and competitive global marketplace.

Microeconomic foundations need to be strengthened and they become far more of a key bellwether of success when a consistent macroeconomic picture is absent.

An average business can look very good in a strong performing economy. They are exposed in a grumpy growth or transitioning environment (refer Theme 2). A larger gap between strong and weak businesses within sectors portends of a lot more consolidation to come across and within industries.

THEME 5: ASIA *ET AL*: TAKING THE STORY FROM THE MACRO TO THE MICRO – IT'S ABOUT EXECUTION

The upshot: The opportunity Asia presents New Zealand is well documented. We put some natural caveats around aspects, but still strongly favour it as a secular theme. Opportunity identification is a necessary, but far from sufficient, condition for real income gains to accrue. It's the speed of advance, along with the quality of execution at the microeconomic level which needs to be watched over the coming years. We've seen some real, constructive shifts in aspects of the microeconomics over the past few years, and fully expect it to continue. However, it needs to be front and centre to keep the mindset on execution.

A lot has been penned in recent years about the macroeconomy and what needs to be done to reinvigorate it. It's been customary to reference the untold opportunities that Asia and other emerging markets offer. Tapping into these opportunities has certainly been a key part of successive government's strategies, with free-trade agreements at the heart of it. We're already seeing evidence of the benefits with exports to China compounding at 18 percent per year since 2000. Great stuff, until you learn China's agriculture imports have been growing in excess of 20 percent. This

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suggests we are undershooting the mark in an area of supposed strength, especially as we've also had the benefit of being the only country with a free-trade agreement with China (in place since 2008).

According to the World Bank and a number of other notable international organisations, the ASEAN trading block and other big players such as China and India, are well short of natural and renewable capital to meet their forecast insatiable lift in food demand. Combine being short of renewable capital with the natural biological constraints in agriculture, under investment over the last 20+ years, urban creep and biofuel production swallowing productive land, water scarcity, a more volatile climate, and government intervention; **these countries and others are going to be increasingly reliant on food imports.**

WEALTH BREAKDOWN FOR SELECTED COUNTRIES (US$/CAPITA)

Economy	Total Wealth	Produced Capital	Natural Capital	Renewable Capital	FTA Status
New Zealand	414,113	76,281	52,979	49,304	N/A
Canada	538,697	89,811	36,924	24,280	No
Australia	518,805	111,671	39,979	19,651	Yes
Norway	861,797	183,078	110,162	10,456	No
Saudi Arabia	146,105	33,000	97,012	10,392	Pending
United States	734,195	100,075	13,822	10,344	Pending
Switzerland	736,795	165,561	9,411	9,411	No
Thailand	37,765	9,711	7,810	7,172	Yes
Indonesia	19,769	3,968	4,926	3,453	Yes
Philippines	19,698	2,745	3,468	3,329	Yes
China	19,234	6,017	4,013	3,209	Yes
UK	662,624	84,861	6,263	3,178	No
South Africa	86,199	11,087	5,723	3,128	No
UAE	349,698	72,873	120,989	2,878	Pending
Vietnam	9,374	1,851	3,630	2,746	Yes
Korea, Rep	248,180	58,636	2,642	2,616	Pending
India	10,539	1,980	2,704	2,351	Pending
Japan	548,751	135,866	2,094	2,047	No
Hong Kong	360,981	77,653	10	10	Yes
Singapore	300,975	81,405	2	2	Yes

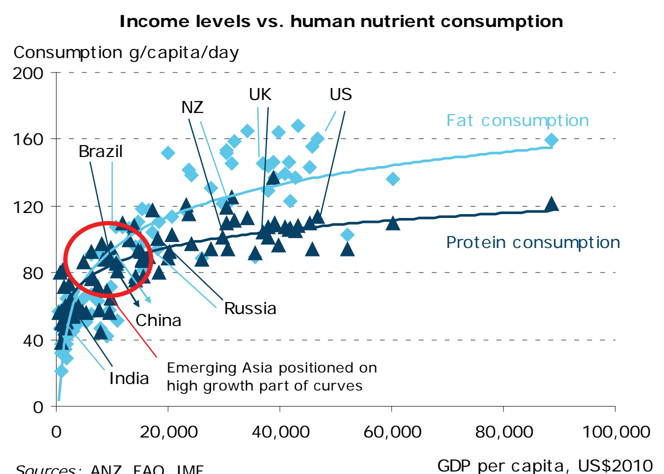
Sources: ANZ, The World Bank "The Changing Wealth of Nations" 2010.

The table above summarises the picture nicely. **New Zealand is effectively "long" renewable capital, much of Asia is "short", and we've either locked in, or are aggressively progressing free-trade agreements.** New Zealand ranks 8th out of 152 countries for natural capital and top of the list for 'renewable' natural capital according to the World Bank. Up to half of our assessed natural endowment is agriculture-focused on crop and pasture land. Furthermore, it is eight times greater than the global average on a per capita basis. Combined with our locality, institutional knowledge in many primary industries, food safety reputation and increasing connectivity (via free-trade agreements with 29 percent of the global population and ongoing negotiations with another 28 percent) this positions us well to seize the untold riches in Asia vis-à-vis other food exporters.

Of course, for the story to unfold, the Asian growth story needs to hang together. Our Asian team are forecasting the continuation of a decent, though not spectacular, economic activity for the Asian region in 2013. The simple reason is that Asia's biggest trading partner region (Europe) will remain missing in action. While China's GDP growth declined to a three-year low in the second half of 2012, growth momentum has since risen. Recent trade and production figures, retail sales and inventory data all point towards a further upturn over coming quarters. With more accommodative monetary policy in place and ongoing fiscal spending, it is expected China will achieve an annual GDP growth rate of 8.1 percent in 2013 a modest improvement on the 7.9 percent achieved in 2012.

However, it is the longer-term story that is more constructive. Asia is becoming increasingly less reliant on trade with the West as internal demand and trade within the region grows. Millions of people are moving from low to middle-income status each year. Infrastructure and communication technology has increased mobility and productivity. Social policy reform, such as life insurance is being implemented to provide safety nets for families, the elderly and sick. This helps reduce the need for savings and lifts consumption. All these factors point toward increasing purchasing power and affluence, which leads to the likes of greater protein and fat consumption.

Income levels vs. human nutrient consumption



Sources: ANZ, FAO, IMF

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We'd also like to issue a couple of caveats on the Asian opportunity. These caveats come in the form of competition, imbalances, and the next leg of the growth curve for the likes of China. **Our competitors are not standing still.** Take the US adding new whole milk powder manufacturing capability in an effort to export a larger proportion of their milk production and cash in on the lucrative Asian powder markets as one example. Secondly, **Asia is not immune to the challenges facing the US, Europe and Japan, to name a few.** Economies are more interconnected today than ever through trade and communication technology. As we all know, the West still faces many challenges. Tough decisions are still to be made and we're set for a drawn-out period of adjustment, making for a period of caution. Thirdly, **Asia must progress towards more economic growth coming from private consumption** instead of being reliant on the traditional export and investment model, especially China. This type of change is a slow moving beast. It requires not only policy change, but also a change in behaviours. So we need to be eyeing how quickly China embraces reform at the microeconomic level. Fourthly, **as China and others move along the developing nation curve, movements in the business cycle will become more pronounced.**

China's largest challenge is making further moves up the income curve. The reality is that most countries who have attempted the move remain ensconced in a low-middle income snare. In China, the combination of capital-deepening investment, additions to the stock of capital and labour, and importation of technology via foreign direct investment are necessary, but not sufficient conditions for achieving high-income status. **The shift requires a profound change in the social order where state dominance morphs into market influence – the key to leaps in total factor productivity.** Productivity is a consequence of efficient resource allocation and sound microeconomic foundations. **Brace for some bumps along that transition for it involves market forces being unleashed.** Certainly not in an unconstrained fashion: you need a regulatory framework. However, you do need to let resources respond to market-based signals for total factor productivity dividends to arrive.

Rather than dwell on the big picture opportunities and risks, we're shifting tack somewhat. In the agribusiness community we've lost track as to how many forums have, and still do, centre around the rather simplistic notion that population and incomes are growing and there is only so much land. **We constantly hear calls for driving efficiency and productivity.** Companies such as Fonterra need more and more production to a) be relevant and maintain its global position and b) service rapidly-developing markets. Efficiency to lift volumes is a key strategic issue for sure. However, these types of calls are rapidly becoming **a core element of being in business as opposed to growing a really good one.**

For the primary industries the gap in the debate and analysis is around the end consumer and channels to market. Such analysis is critical to boost understanding, and ensure we target specific consumers, food categories, and the corresponding consumer channels offering the highest margins and least risk. This is all part of increasing market sophistication across Asia as the macroeconomic trends intertwine with local specifics such as food safety concerns and culture, which affects consumer trends, brand preferences, tastes and business practices.

Also while opportunity identification is a necessary, it is far from sufficient condition to reinvigorate the New Zealand economy. The latter requires "walking the talk", or the development of strategies to capture the identified opportunity and then successful execution of a chosen strategy. In reality most of the major agribusiness industries, the tourism sector and others have already developed strategies around the Asian opportunity with some on to their second, third, or fourth iteration. In fact, we believe this facet is under-appreciated: all the agri-industries have moved beyond identification and into execution (and we believe New Zealand is well ahead of Australia in this regard). **The successful execution of these strategies is the next leg on which we're looking for guidance and evidence.** The problem here is that benchmarking such progress typically doesn't happen until you see it in the macroeconomic figures. We're after earlier signals than that, which is why we're eyeing all the small things at the microeconomic level.

So what are some of the examples and bellwethers in the microeconomic arena to watch? Examples include:

- **Fonterra delivering on its new strategic path and taking the rural sector with it.** The latter requires more communication about the strategy itself as opposed to the opportunities: we know about the latter, we want to understand the strategy and see it in action. **It's there, it just needs wider circulation, articulation and appreciation.** Several of the strategies are heavily focused on the Asian story, but each has a twist. One example is growing its position in mobility through its Anlene bone

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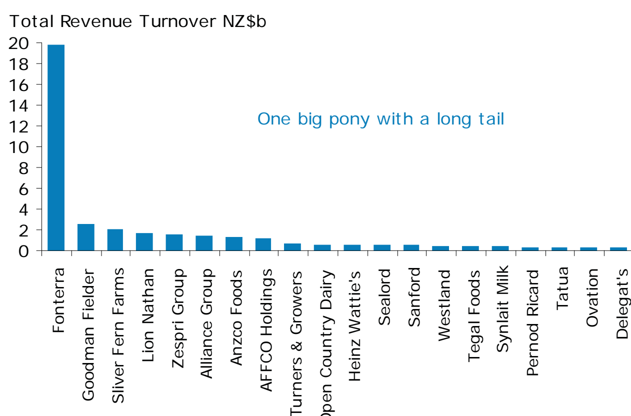
health brand as well as other new products. This hooks into the likes of China's large population, but also recognises Chinese people are ageing, with 1 in 3 expected to be of retirement age in 2050, compared with 1 in 9 currently. **Subject to management execution, the upside of delivering on this and other consumer business strategies would be significant for its earnings outlook.** As an example, if half of its current sales mix can be migrated from the low margin (3 percent EBIT) and low return ingredient biased operations to the higher margin (>11 percent EBIT) consumer-branded dairy product businesses in Asia/AME and LATAM it could deliver up to NZ$400mn (40 percent) in additional EBIT. This will not happen overnight, but Fonterra's product and earnings mix are worth watching with such strategies now centre stage. The successful launch of TAF is another key peg in the ground which shows Fonterra are making progress.

- **Rationalisation and consolidation within the meat industry so the food and beverage sector can overcome its "one big pony with a long tail" look.** We liked the spirit of the red-meat sector strategy report released in March 2011, but question whether it went far enough and progress on some of the initiatives nearly two years on seems slow. The sheep flock is declining, the ROE on sheep farming is poor, there is excess capacity across the processing sector, collectively meat processors suffered record losses last year, and our major markets in Europe are depressed. If farmers are having "good" times, processors are experiencing "poor" times and vice versa. **Put simply, the economics for sheep farming do not stack up.** To be fair, it's been a struggle for some time. We simply seem to be closer to an inflection point where a tipping point drives necessary changes. Muddling through is not a strategy. More scale is required to help fill in the missing middle in New Zealand's food and beverage companies.

Major food and beverage companies in New Zealand



Sources: ANZ, Listed Companies Annual Reports

- **If you think the meat industry is dysfunctional, the wool industry is worse and in need of rationalisation and consolidation.** While there have been some notable new initiatives floated to promote rationalisation, new thinking and investment in product development and marketing, by-and-large none are yet to get fully off the ground with critical mass. Support from farmers has been poor as past failures have coloured thinking, leading to a reluctance to commit and invest. **If the economics of sheep farming are to improve then dramatic structural change is first required beyond the farm-gate in the wool industry. For this to occur, farmers need to invest and pin their colours to one mast.**

- **The composition of boards and governance in the agri-space must keep evolving.** More cultural diversity, marketing expertise, outside thinking and input from the younger generation are crucial.

- **Consolidation, or collaboration within smaller niche sectors to deliver to the scale requirements of Asia and others.** Small-medium-sized enterprises trying to access export markets usually don't have sufficient scale to service the market and face significant sunk costs accessing and developing new markets. **They also face a market failure situation where the benefits of individual investment often accrues to others,** hence firms under-invest, or tend to free-ride off others. We are starting to see consolidation in the wine sector where groups of wineries are collaborating to supply larger clients, such as a particular supermarket or hotel chain, as it is impossible to meet volume requirements by themselves. The New Zealand Hops grower-owned co-operative is another example of collaboration between growers in a small niche sector to access a lucrative export market. They supply 50 percent of their unique aroma and bittering varieties to the US craft beer market. Scale is required as a craft brewer in the US is a lot bigger than in New Zealand.

- **Signs that farmers are moving up the performance curve, with the focus on profit and less on capital gain.** Most farmers think they are in the top 20 percent of performers: the reality is that 80 percent aren't. Just over half of all profits in the meat and fibre sector accrue to the top 20 percent of farmers.

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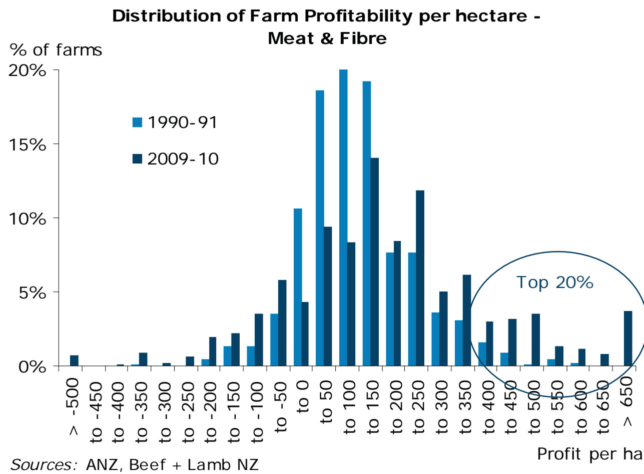
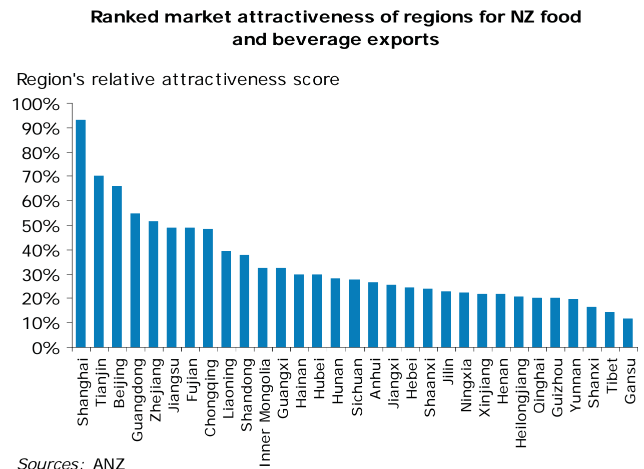


Sources: ANZ, Beef + Lamb NZ

Rural financiers are increasingly focused on debt servicing ability/cashflow and less so on security, which is helping to drive a mindset change from capital gain to profit. Regulatory changes on farm borrowing are also assisting here. **A host of other good stuff has been going on over the past few years** to help support the move up the performance curve and change the mindset, and often it's in the form of small forums exchanging information and techniques. Large organisations – Fonterra, the fertilizer co-operatives, meat companies, PGG Wrightsons, etc are showing "skin in the game", co-ordinating with national groups (Beef + Lamb NZ) and central government to actively sponsor and lead performance forums. These forums now attract more than a 100 as opposed to less than 50 attendees with farmers often travelling long distances to attend. **This momentum has been startling to watch over the past three years, and needs to continue.** On every New Zealander's "bucket list" should be Mystery Creek and the National Fieldays in June: you will come away with a different notion of farming, such has been the structural evolution across the industry.

- **Evidence we're starting to understand the end-consumer and channels to markets more and more.** Some good progress is taking place in this space also. Businesses are employing local experts to help understand and overcome communication and cultural issues. They are boarding planes and attending trade shows to see and talk to customers. However, this needs to step up a gear. A good example is New Zealand wine growers and New Zealand Trade and Enterprise who are working together with wineries to educate Asian markets about wine. Wine appreciation courses are often over-subscribed by a factor of three in China. Drinking wine in China is different to drinking wine anywhere else. The Chinese traditionally pour wine into small glasses and drink it quickly. However, the younger generation is learning to think differently to the older generation. So while they currently enjoy/use wine in a different way the younger generation are out exploring the world, learning about food and wine and developing their tastes. Education, such as wine appreciation courses, helps them learn to taste and appreciate the wine, or the food and wine pairing.



Sources: ANZ

- **Identifying wealth and opportunities is one thing, but to be successful New Zealand will also need to identify markets that offer facets that are complementary to the basket of goods we can provide, such as refrigeration and distribution functionality.** As an example, for China, we have derived a proxy variable using seven indicators with equal weighting to rank the main regions for market attractiveness of New Zealand food and beverage exports. **The most attractive regions are on the East Coast seaboard with Shanghai, Tianjin and Beijing ranking as the top three.** These regions are densely populated, have more purchasing power, spend more on New Zealand oriented food products, and have a robust cool chain and distribution network. To put these three regions in perspective, they have a combined population of 57.3 million, just over two and half times the size of our largest trading partner Australia.
- **Resolving farm succession is a key challenge for many sectors that face demographic challenges.** Farm succession is unique to each individual situation and market conditions will be relevant (i.e. land prices), but there is still a strong desire in the agri space to pass on the business to family. In fact a whopping 61

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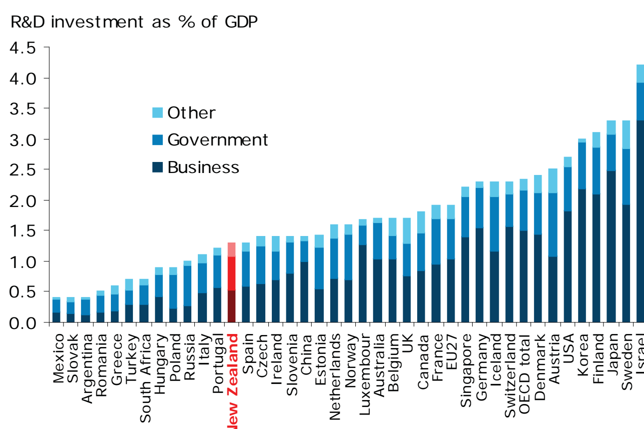
percent of farmers see this as their succession plan, compared with just 18 percent of non-agribusiness owners. **Farmers look a little more advanced than non-agribusiness in that over 50 percent are developing a plan, or already have one in place.** The successful execution of these plans will ultimately determine the future direction of sectors.

- **Increasing the pool of talent with appropriate degrees and skill-sets aligned with business' needs.** This involves encouraging more high school students into degrees related to science, engineering, business, agriculture, finance, marketing and information technology, and fewer into the arts. It also involves retaining them in New Zealand once they're trained. Closer collaboration, such as the Agri One Ltd joint venture between Lincoln and Massey University, to offer short courses/professional development opportunities aimed at specific areas is another example of innovation in the education sector that helps upskill existing professionals.

- **Boosting research and develop expenditure and the commercialisation of this investment. In the agri space it has been estimated that research and development investment has led to an estimated 17 percent rate of return, providing a compelling case for more.** Certainly, with New Zealand research and development investment languishing around 1.3 percent of GDP, compared with the OECD average of 2.0-2.5 percent, there is a good case for more. There are many examples here, such as the development of different varieties of kiwifruit (despite present Psa challenges). Introduction of the Gold variety has tripled the value a grower earns from a hectare of land compared with the traditional Hayward Green variety. The Primary Growth Partnership promises to deliver more, but businesses need to put their hands into their pockets more often going forward and look for collaboration opportunities.



Sources: ANZ, OECD

- **Greater palatability from the rural sector towards environment issues and how a pure/clean/green image can be monetised. There is some momentum growing** with more on and off farm investment going into this area. The dairy industry has recently come up with a successor to the "Clean Stream Accord" called the "Sustainable Dairying: Water Accord". It centres around a step change in the management of risks to waterways from dairying through effluent, waterway and nitrogen management. Annual audits are included, along with support mechanisms for education, training and facilitation of best practice for all three aspects of water management. New Zealand's clean and green image is a source of strategic leverage and future market premium.

- **Steps aimed at encouraging Asian tourists to stay longer and experience New Zealand in different ways i.e. choosing to study in New Zealand.** The total number of tourists visiting from Asia (excluding Japan) has more than doubled since 2000 with **Chinese visitors leading the charge to become New Zealand's second largest source of tourists.** While the length of stay is less for Asian tourists compared with their Anglo-Saxon counterparts, their average expenditure per trip is higher. **Therefore, attracting them to stay longer will be key, but other add-ons such as encouraging them, or other family members to come back to study just as important.** Collaboration between the likes of the tourism and education sector is important to seize such opportunities. The strategic game-plans of Auckland International Airport and Air New Zealand are flag-bearers for the wider tourism industry also: their strategic visions need to be articulated and supported widely. The successful execution of these strategies will bring huge positive externalities to the wider economy and the tourism industry in particular. Once again we're after evidence the industry is changing and understanding the end consumer. Are we seeing a massive change across tourism hot-spots such as Queenstown? Not really.

- **Can we move on from the Auckland vs. the rest of New Zealand mentality?** Auckland is critically important to NZ.Inc. It has size and scale. Auckland's comparative advantages are not solely Auckland-centric. Auckland is the natural representation and gateway to access and facilitate the broader New Zealand story.

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Embracing this is the upside for Auckland, and New Zealand. Auckland and the rest of New Zealand's fortunes are intertwined.

This is not a complete list, but highlights just a selection of examples of what we are looking for over the year. **It is not a list of criticisms. It offers a glass half-full view of where New Zealand is headed if progress in such microeconomic areas continues.** They are not big-bang initiatives, rather a combination of little things in the microeconomic arena, which if executed well, will deliver macroeconomic punch.

Many of our flagged bellwethers are underway. It's been tremendously encouraging to see significant shifts over the past few years. Certainly New Zealand looks well ahead of Australia in the microeconomic arena and particularly in the rural scene. **We're simply looking for it to step up a gear further.**

THEME 6: ALL ABOUT JOBS

The upshot: The labour market is the key macro variable to watch in 2013. In the US (and NZ), jobs have been the key missing ingredient in the tepid recovery thus far. Low global interest rates for an extended period in response to soggy labour market conditions will be one factor keeping the NZD elevated vis-à-vis peers. We expect a gradual and slow improvement in New Zealand's job scene over 2013, with it front and centre as an issue in the political arena. The influence of a polarised compass (Theme 4) and signs of diminished job matching efficiency will be reflected in greater dispersion across labour market statistics. We're looking for constructive policy initiatives to help ease such frictions. We'll see some, though expect them to fall short of being the step-change variety.

Why is the labour market key to watch in 2013?

- Internationally, it will have a huge bearing on when the US Federal Reserve starts to unwind its extraordinary policy stimulus, a precursor to the NZD/USD correcting to more New Zealand-friendly levels.
- There is a huge social cost from structural shifts upward in unemployment.
- Trans-Tasman relative employment prospects are a huge driver of migration flows.
- Recent fillips in the property market will not be sustained without a commensurate labour market improvement.
- Spare capacity across the labour market is a key influence on wage growth, core inflation and the outlook for the OCR.
- We're in the middle year of the election cycle: voters need to see payback following some tough years if a new broom is to be avoided. Employment will be a hot political issue in 2013.
- Structural changes in the demand side of the economy as rebalancing continues and a different mix to growth unfolds will ultimately need to be matched by shifts in supply-side capacity. The education sector and migration flows (both nationally and between regions) are key.
- Productivity. Our nationwide labour productivity performance has been poor in relation to OECD peers.
- Hysteresis effects. Labour market outcomes tend to be persistent, notwithstanding the volatility of some quarterly surveys. Turning around ingrained trends and practices will not happen overnight. Once out of work it can get progressively harder to reintegrate back into the workforce.

The labour market remains fragmented. The unemployment rate rose from 6.4 to 7.3 percent over the first nine months of 2012. A quick look "under the bonnet" suggests conditions are a bit better than the unemployment rate is showing. The past year has seen a decrease of nearly 6,000 people on the unemployment benefit, which suggests the official unemployment rate figures could be overstating the reality and understating employment growth, though falls in beneficiary figures are also likely to reflect tough eligibility criteria.

The unemployment rate for those aged 30 and above is around 4.8 percent, which is not far off "full employment", though a far cry from what we were seeing during the housing boom times, when the likes of the 40+ group had an unemployment rate of 2 percent! However, the unemployment rates for those aged 15-19, 20-24 and 25-29 are 26.6 percent, 13.2 percent and 7.9 percent respectively (note: all figures are seasonally-adjusted estimates). Unemployment rate figures for young age cohorts have risen more sharply than those for older age groups, and are well north of their historical averages. Such figures are social and economic time-bombs if not addressed.

Employment indicators are equally mixed. Job ads – a timely barometer – have been moving sideways for an extended period and the level remains low, the exception being Christchurch, which has shown a strong lift. Employment intentions have been positive for some time, though we note that business sentiment measures for activity, employment and investment have been disconnected with actual outcomes for a while. Firms are noting skill shortages in some areas.

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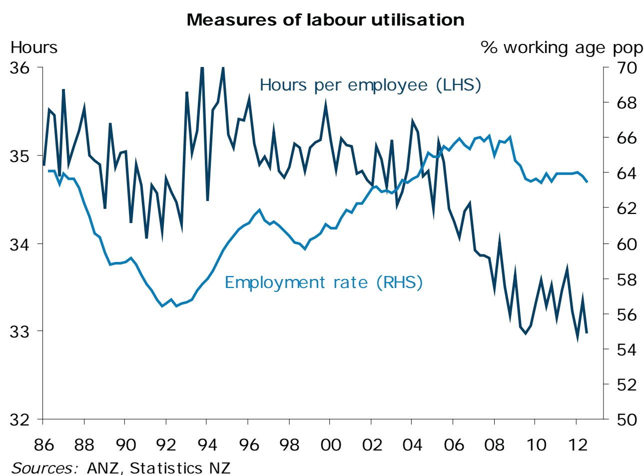
History has shown the unemployment rate can come rocketing down when the right economic climate appears. Between 1991 and 1995 the unemployment rate dropped from 11 percent to just over 6 percent. It was below 4 percent for much of the 2005/07 period. When you look for a catalyst for this to reoccur it's hard to go past Christchurch, with around a 75 percent lift in newspaper and internet job advertising compared to the months prior to the February 2011 quake.

However, right here and now we also know that:

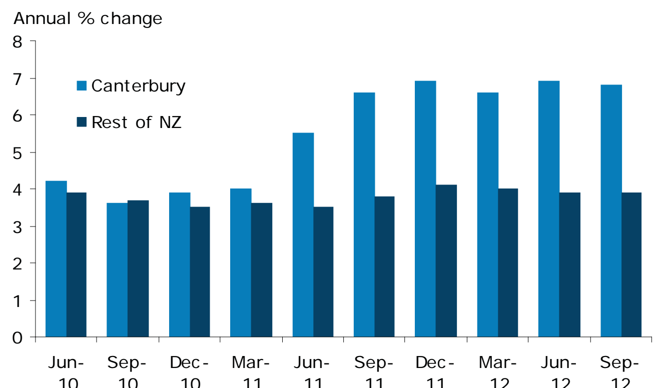
- **There is spare capacity in the labour market.** Commentary typically focuses on the unemployment rate. Yet when you look at measures such as hours per employee sitting around record lows, or measures of underemployment (those that would like to work more hours), it is clear that considerable slack remains. When labour demand starts to recover, there is ample scope to increase the hours of the existing workforce to meet that demand without needing to take on new staff. **The end result: a jobless recovery.**



Sources: ANZ, Statistics NZ

- **It's taking time for resources such as labour to respond to market signals and structural shifts across the economy.** New Zealand is still by-and-large churning out the same student mix we did four years ago, yet that economic model is now broken. This is not where the sustainable job growth is. Little wonder graduates are frustrated and increasingly looking overseas. In the meantime, facing mixed economic signals businesses battle on, seeking what limited growth they can eke out, and increasingly attention returns to costs. In a different demand/growth environment, the cost line equally gets tweaked.

For a host of industries, the regularity by which costs lines are being examined is becoming the "Groundhog Day" of yearly nightmares. And for some pockets, it has really only just begun.



Sources: ANZ, Statistics NZ

- **The labour market is becoming increasingly polarised** between the skilled and unskilled. These kinds of frictions are an inevitable by-product of the kind of rebalancing of growth that New Zealand requires. The economy faces a challenging period, rebalancing from spending to earning at the same time it rebuilds a city. The construction sector is where the most obvious tensions will play out. The sector has lost staff and expertise to Australia in recent years, and while there are signs that industry training is likely to step up, it will not immediately address capacity constraints in the sector. Greater dispersion in wage settlements is becoming apparent.
- **The labour market is not perfectly mobile.** So while jobs growth may be pending in the South Island and Christchurch in particular, physically relocating resources imposes challenges. People like to be near family and whanau. Kids are in schools. Relocation in two-income households is more difficult and faces a higher hurdle, given the potential loss of a second income. If you are considering shifting, better opportunities (and weather) may also be on offer across the Tasman.
- **There are some signs of diminished matching efficiency (i.e. the ratio of vacancies to the unemployed) across the labour market.** Traditional tight relationships between the unemployment rate and skills shortages have gone awry. Recent work by the RBNZ (*"Matching workers with jobs: how well is the New Zealand labour market doing"*, December 2012 RBNZ Bulletin) points to a decline in matching efficiency

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considering the Beveridge curve (the relationship between vacancies and unemployment) and an estimated proxy measure of matching effectiveness.

So, we have a situation heavy in fragmentation and tension.

Internationally, a surfeit of labour resources in the US looks set to keep the US Federal Reserve on hold until the unemployment rate gets to 6.5 percent. Europe has got a structural unemployment problem on top of a cyclical one and can't address the latter, let alone the former. The Australian "jobs machine" has done a Lange and stopped for a cup-of-tea, with job ads down 16 percent on a year ago. The bottom line in all of this is that other central banks will keep interest rates low and this means the NZD will remain high. Suddenly the incentives to emigrate don't look so great, and in the case of trans-Tasman flows, we're likely to see more people returning, and no doubt they'll flock to Auckland, exacerbating housing issues.

Looking forward, the election cycle will demand that employment receives top billing as a local issue. Elections are won or lost on unemployment tilts, particularly once the electorate moves past the honeymoon stage associated with the first political term. So the incentives are with the incumbents to act. Christchurch's rebuild represents a prime opportunity to trial a working for the unemployment benefit scheme. The argument against such ideas is that they can displace real jobs. This won't happen in Christchurch such is the demand! The plethora of tertiary training institutes should be consolidated and institutions made to specialise more. Student fee structures should ideally be more aligned to resource pressures and skill mismatches. Of course, none of these ideas will make the cut when the announcements come. We'll see some tinkering and not much more.

We expect the unemployment rate to end 2013 with a 6 percent handle in front of it as opposed to a 7. While employment indicators from confidence surveys are reasonable, job advertisements have been flat-lining which means the job vacancy rate has been rising. Firms remain cautious pulling the hiring trigger. **However, a key assumption we are making is that more consistency on the GDP front (eking out something marginally above two percent** – a rough breakeven rate for unemployment to go up or down), **delivers modest employment growth over the year.** We'll take it, but it'll hardly be an environment where job security is strong. **Better job prospects will be welcome, though the pace of improvement, uncertainty and fragmentation is expected to keep households cautious and focused on improving their precautionary saving buffer.**

Outcomes across the labour market will be more divergent than convergent. This is already occurring across wage inflation measures such as the labour cost index. We'll see more. In a typical economic expansion, dictated by cyclical dynamics, the fortunes of all tend to be heavily intertwined. A rising tide lifts all boats. However, when you are buffeted by both structural and cyclical forces, outcomes become more divergent. Skills shortages emerge more quickly in sectors that have been under-invested in. Conversely, sectors (and employees in them) which have excess supply-side capacity and are facing structural headwinds such as deleveraging, tend to suffer (and yes, banking is one of these).

THE MONTH IN REVIEW

ASSESSMENT

Rain in late-December saved much of the country from becoming too dry at the start of summer. More recently the North Island has begun to dry out again, whereas most of the South Island received good rain in mid-January to keep things going. Dairy farmers' fortunes have improved despite production normalising somewhat, the advent of mixed weather, and a fright from the discovery of Dicyandiamide (DCD) in milk. Things have not been so chipper for sheep farmers as the realisation of lower sheep and wool prices set in.

In the North Island, the east coast from Napier south has been struggling the most of any region with very dry conditions over summer. However, the dry conditions appear localised, as some farmers have been lucky enough to receive rain from thunderstorms. Further North, parts of the Bay of Plenty and from Waikato up have also started to dry out quickly. **What seems to have exacerbated the current situation is the lack of a spring flush over much of the country. This meant there was not a lot of excess feed carried over into the summer period.** Therefore, as conditions have turned summery, regions that have not received rain are either short of, or quickly becoming short of feed.

DAIRY

Despite mixed weather conditions in some regions **things have been looking a bit better for most dairy farmers. There was the successful launch of TAF,** with the share price defying gravity and trading above $7.00 per share in January. This exceeded all predictions, even the experts'. This has effectively added 9 percent, or $350,000, to an average dairy farmer's equity position. One advantage of TAF, and the three-year rolling average for the share standard, is that farmers now have the flexibility to use some of this equity when required.

Fonterra also upgraded its milk price forecast to $5.50 per kg MS for the 2012-13 season and increased its advance to $4.25 per kg MS for January through to May. This has helped to relieve many budgets experiencing tight cash flow. For the average dairy farmer this adds an extra $35,000, or 4.5 percent extra to revenue lines. **The move may not seem large, but if the milk price moves into the low fives the proportion of farmers that would register a cash-loss will quickly move higher.** As our previous analysis has shown, 22 percent of dairy farmers will still register a cash loss at a milk price of $5.50 per kg MS, nearly double the five-year average.

On the production front **it looks like dairy farmers will eclipse last year's all-time record due to a strong first half.** Milk production for the first half of the 2012-13 season is estimated to be up 6 percent on last year. While there was a long tail to production last year, milk flows would need to be back 6 percent for the remainder of the year not to register any overall increase. At this stage it would seem a small increase of 2-3 percent for the season is plausible, as North Island production tails off early due to dry conditions, but the South Island continues to perform solidly.

The industry has received a fright from the discovery of minute traces of DCD in NZ milk. The trade risks are obvious, but swift action banning its use by fertiliser companies would seem to have mitigated this. The bigger concern is that dairy farmers' toolboxes for tackling increasing environmental regulations just became emptier, especially options for limiting nitrate run-off into waterways. **Increasing environmental regulation, combined with the effective banning of DCD, potentially limits future gains in milk production, and perhaps even reduces potential production in certain regions.**

MEAT AND FIBRE

Things have not been so chipper for sheep farmers as the realisation of what lower lamb and wool prices mean for the bottom-line sets in. Beef + Lamb NZ's latest forecast predicts a 17 percent drop in revenue from sheep and wool sales for the average farmer. While the wool price used to derive the prediction looks close to the mark, the lamb price looks a little high. This suggests the revenue from sheep sales could drop even further. For those on the east coast of the North Island the dry conditions have been a double blow. The lower prime prices and dry conditions in the North Island have been reflected in the store market, with breeding and finishing stock fetching only around half the prices paid 12 months ago. **The news has not been all bad though, with cattle and venison prices still solid.**

Overall, the dry conditions in the North Island, along with the extra 1 million lambs born in the spring, have seen lamb slaughter increase 21 percent on last year. In contrast, the South Island is back 2 percent. **This leaves total lamb slaughter 8 percent ahead of last year, but still 15 percent behind the five-year average.** Cattle have also been turned-off early due to a lack of suitable feed and reasonable prices. This has boosted the North Island cattle slaughter by 17 percent y/y. But this is in line with the five-year average, as farmers held onto cattle last season to control ample grass growth. **Elsewhere, early forecasts are the Gold kiwifruit crop will be only 12-13 million trays, around half the average of the last five years.** With 70 percent of NZ's kiwifruit area now infected with Psa, the green crop is also expected to be smaller this season.

ANZ

RURAL PROPERTY MARKET

SUMMARY

Activity data from spring-listed rural properties going unconditional has started to flow through and is painting a stronger-than-expected picture. Overall, the number of farms sold and average price have strengthened over the past three months and compared with last year. However, price movements have been somewhat uneven across the different farm types and regions, reflecting the lack of a clear trend driving the property market. For new dairy conversions and existing dairy farms it will be interesting to see how the higher share price will affect land values. So far going concern prices for existing dairy farms have been unchanged, implying a lower land valuation.

Activity data from the last two three-month periods has been stronger than expected. Turnover for all the different land types increased, but movements in the average price achieved were mixed.

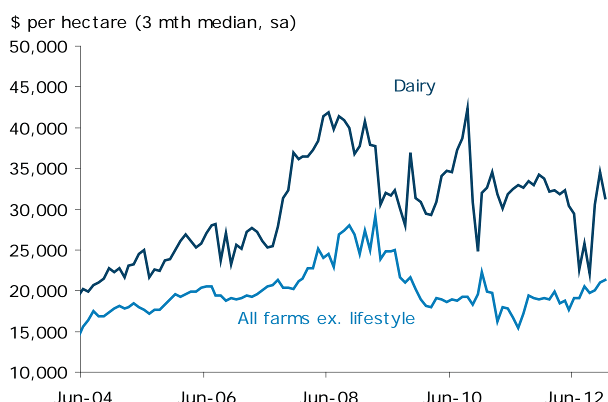
The mixed movements in price reflect the wide variation in the quality of properties sold, but also the many competing drivers: interest rates certainly remain favourable; there are buyers with strong balance sheets; low inflation will be helping moderate cost pressures; and offshore investors are still keen for exposure to NZ's agriculture story. Conversely for commodity prices it depends on the sector (milk up, sheep/wool down), as does production (milk okay, dry conditions affecting livestock weights in the North Island), there is still a significant proportion of farmers with weak balance sheets and the setting/implementation of more environmental regulation continues in many regions.

The table and charts below show the official statistics from REINZ for farm sales in the 3-month period ending December. The table is broken down into farm sales by each of the main farm types, both the number of sales during the 3-month period, and the median price per hectare. The figures have been seasonally adjusted and therefore the components may not necessarily add to the total. While the data is volatile, it is the best available on current market conditions.

FARM SALES BY FARM TYPE

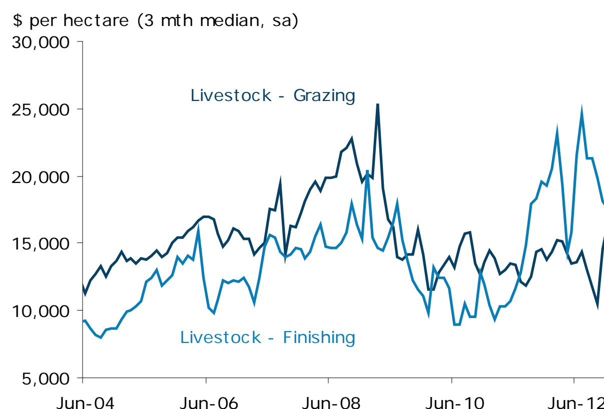
3-Month Seasonally Adjusted		Current Period	Previous Period	Last Year	10-Year Average	Chg. P/P	Chg. Y/Y	Chg. P/10yr
Dairy	Number of Sales	54	47	43	76	↑	↑	↓
	Median Price ($ per ha)	31,300	34,500	33,700	28,400	↓	↓	↑
Livestock – Finishing	Number of Sales	75	66	66	65	↑	↑	↑
	Median Price ($ per ha)	17,600	18,100	19,300	12,900	↓	↓	↑
Livestock – Grazing	Number of Sales	179	144	200	239	↑	↓	↓
	Median Price ($ per ha)	16,400	14,600	14,000	14,700	↑	↑	↑
Horticulture	Number of Sales	32	31	22	53	↑	↑	↓
	Median Price ($ per ha)	87,100	88,700	135,900	146,800	↓	↓	↓
Arable	Number of Sales	22	17	16	19	↑	↑	↑
	Median Price ($ per ha)	24,900	28,400	20,500	24,800	↓	↑	↑
All Farms ex. Lifestyle	Number of Sales	373	324	345	486	↑	↑	↓
	Median Price ($ per ha)	21,400	21,000	19,000	19,200	↑	↑	↑
Lifestyle	Number of Sales	1,594	1,492	1,241	1,620	↑	↑	↓
	Median Price	475,000	476,000	462,000	396,000	↓	↑	↑

Farm Sales, Median Price



Sources: ANZ, REINZ

Farm Sales, Median Price



Sources: ANZ, REINZ

ANZ

RURAL PROPERTY MARKET

Two interesting developments over the last two months could influence dairy and finishing property prices:

1. **The implementation of TAF by Fonterra and a sky-rocketing share price** that has traded above $7.00 in January. This is up 50 percent or $2.50+ from the regime that was used in the 2011-12 season.
2. **The suspension of the use of DCD** by the two fertiliser companies after minute traces were discovered in milk.

The implementation of TAF and the sky rocketing share price could arguably have implications for dairying land values, as well as land that can be converted, or used for dairy support. **So far the anecdotal evidence is that the overall price for dairy farms of a similar quality sold as a going concern remains unchanged compared with pre-TAF.** This implies a lower value is being paid for the land & buildings component of the business, as farmers seem reluctant to accept a lower rate of return.

If shares are being valued at the $7.00 per share for example (the level at which they traded above for January), then this effectively means an extra 9 percent, or $350,000 worth of capital is required to buy an average dairy farm. If this extra capital is taken off the going concern price, it implies a land & buildings valuation that is $2,500/ha lower for the average dairy farm post the launch of TAF. Of course the flipside could also apply here, if the share price had collapsed, or ever did, to $2.00 per share for example and the going concern price of a dairy farm remained unchanged then the land and buildings valuation is by default higher. **The evidence so far is that both the land value and share price remain interlinked as farmers are interested in the overall rate of return on capital employed.** That means more evidence will need to be gathered on a long-run share price under TAF to be able to assess the value of land when a business has been sold as a going concern.

The other factor that could impact on dairy land values is the suspension of the use of DCD after minute traces were discovered in milk, and it was deemed a trade risk. **For dairy farmers who are facing increasing regulation to limit nitrate run-off into waterways, not having this tool available will limit their options** in periods such as the autumn and spring to reduce this environmental externality. **This potentially limits future gains in milk production, and perhaps even reduces sustainable production levels in certain dairying regions.** Hence a more cautious assessment of production is likely to be undertaken, especially in regions that are more advanced in limiting nitrate run-off. Such tensions show that it will take some time for the farming community to be able to adapt to any new environmental regulations.

Examining the backward-looking indicators for the rural property market on page 24 shows **that the average price was $21,400/ha for the 3-month period ending December.** This was the highest average price achieved for two years. While the **composition of sales often influences the average price, the mix of farm types sold has been reasonably stable over the past six months. In total, 373 farms changed hands in the 3-month period ending December, which equated to 77 percent of the 10-year average.** The turnover of all farm types has improved since the middle of 2012. However, compared with this time last year, the turnover of dairy, finishing and arable land is stable, horticulture has improved from its lows, but grazing is back 20 percent. The decline in turnover of grazing properties no doubt reflects the softer outlook for the sheep industry.

The turnover of dairy properties has been stronger than expected, improving back toward 70 percent of its 10-year average in the 3-month period ending December. The average price achieved was back on November at $31,300/ha, but is only $900/ha less than the post GFC average of $32,200/ha. In the month of **December, 35 dairy farms were sold with an average sale value of $33,700/ha, or $36 per MS.** The average farm size was 89 hectares and the average production/ha was 945 kgs of MS. **In November 22 dairy farms were sold with an average sale price of $40,600/ha, or $42 per MS.** The average farm size was 96 hectares and the average production/ha was 976 kgs of MS.

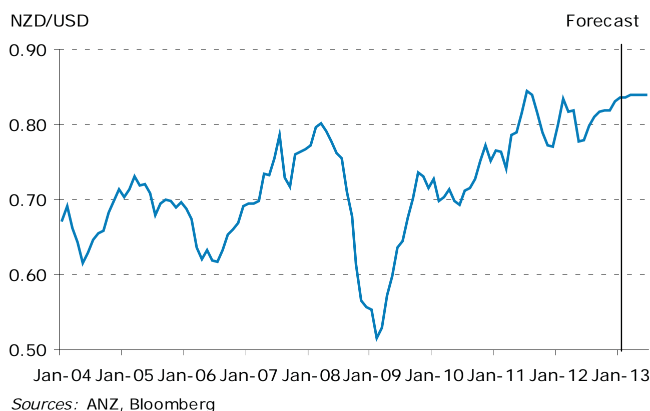
Finishing land prices have softened a touch, but turnover remains high, especially in dairying hotspots. In fact November and December turnover beat the 10-year average. The average price achieved dropped to $17,600/ha for the 3-month period ending December. This was only slightly outside the range of $19,500-22,500/ha achieved over the last 12 months. **The trend still remains up, but looks like it is beginning to mature, with prices sitting nearly 40 percent above the 10-year average.** Arable land sales have also been solid, with both turnover and prices very close to their 10-year average, and up on last year. In contrast, while the average grazing price bounced in December, this was largely due to the composition of sales. With softer returns for sheep and wool, turnover is expected to remain soft and average prices flat at best for grazing properties.

Horticultural sales have been steady, but the average price has been soft, reflecting the type of blocks sold. Turnover was 60 percent of its 10-year average in the three months ending December and the average price was $87,000/ha.

ANZ

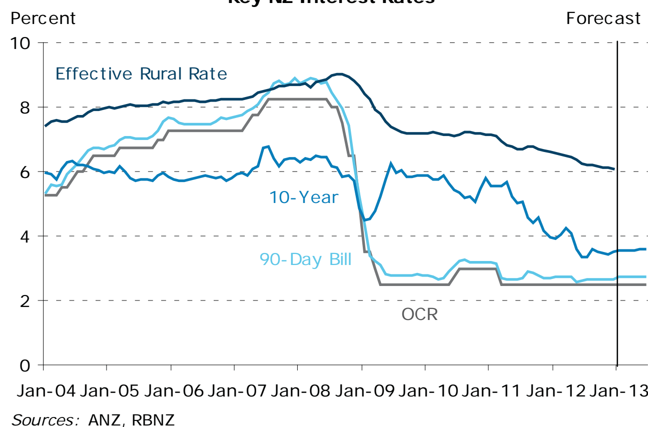
ECONOMIC INDICATORS

EXCHANGE RATES	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
NZD/USD	0.83	0.83	0.80	↑	↑
NZD/EUR	0.64	0.63	0.62	↑	↑
NZD/GBP	0.53	0.52	0.52	↑	↑
NZD/AUD	0.80	0.79	0.77	↑	↑
NZD/JPY	69.8	69.5	61.6	↑	↑
NZD/TWI	74.4	74.4	72.8	↑	↑



Sources: ANZ, Bloomberg

NZ INTEREST RATES	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Official Cash Rate	2.50	2.50	2.50	↔	↔
90 Day Bill Rate	2.75	2.65	2.74	↑	↑
1 yr	2.60	2.52	2.48	↑	↑
2 yr	2.62	2.54	2.59	↑	↑
3 yr	2.76	2.63	2.74	↑	↑
5 yr	3.19	2.54	3.16	↑	↑
10 yr	3.57	3.52	3.93	↑	↓
Effective Rural Rate	6.09	6.12	6.59	↓	↓
Agricultural Debt ($b)	49.05	48.74	46.68	↑	↑



Sources: ANZ, RBNZ

The NZD is set to remain elevated courtesy of USD weakness and offshore investment in NZ bonds. However incremental pushes higher from this point seem difficult. 1. Valuations are already stretched. 2. There are clear signs of collateral damage emerging locally from the higher NZD. 3. Globally, domestic drivers of growth are picking up, reducing some countries reliance on currency weakness to "buy" growth.

Although further substantial gains in NZD/USD are less likely given the improving outlook for US growth, we do expect the Kiwi to remain elevated. The major driving force behind the higher NZD has been broad-based USD weakness and offshore investment in NZ bonds. Although valuations are stretched and the dynamics are changing as US interest rates rise, the Federal Reserve remains committed to QE, and will likely be lifting rates after the RBNZ. The higher starting point for NZ interest rates also means that the local bond market will be more robust to a rise in yields, making it an attractive defensive play for foreign investors. **Against such a backdrop, we expect investment inflows to continue, keeping the NZD elevated.**

These dynamics will also keep a lid on local long term interest rates. While the gradual rise in global interest rates suggests local-term interest rates may rise, if investor demand remains strong as we expect, this will be offset to an extent by a narrowing of interest rates between NZ and US.

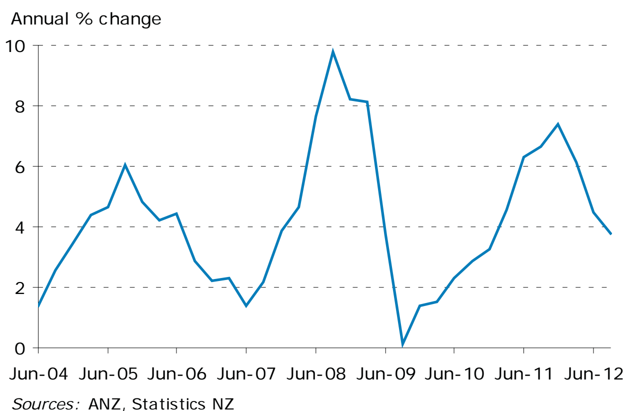
For short-term interest rates, the key consideration is; when the Reserve Bank will start raising the OCR. Currently the RBNZ remain reasonably comfortable on the growth outlook, with business confidence and construction activity recovering from mid-2012 softness. The RBNZ also expect a strengthening in global activity over 2013, with low interest rates supporting global sentiment and financial conditions. The Canterbury rebuild remains the major domestic growth engine, with the rebuild gaining momentum and the domestic demand impact broadening. Offsetting this is the high NZD impact on the tradable sector, the impact of fiscal consolidation, and the weak labour market.

We continue to look to an early 2014 start to the tightening cycle, but even then there are caveats – not the least of which are the less than rosy outlook for jobs, low inflation, and the potential for prudential policy to play a greater role. Add to that growing frustration with the strength of the NZD and you hardly have grounds to tighten policy. **Accordingly, we expect interest rates to remain subdued, giving borrowers more time to "enjoy" low floating and short-term fixed rates.**

ECONOMIC INDICATORS

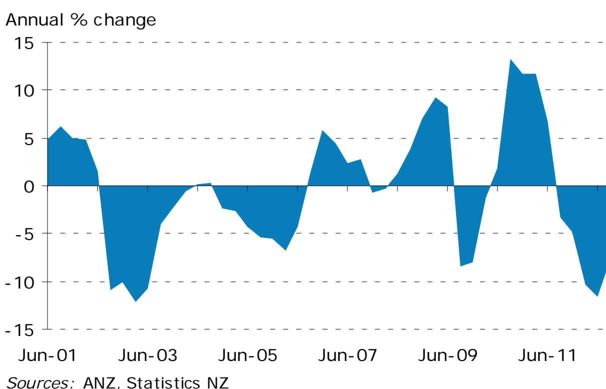
INFLATION GAUGES					
Annual % change	Current Qtr	Last Qtr	Last Year	Chg. Q/Q	Chg. Y/Y
Consumer Price Index	0.9	0.8	1.8	↑	↓
Farm Input	3.8	4.5	6.7	↓	↓
Net Imp. Margins PPI	–7.6	-11.5	-3.3	↑	↓

Farm Input Inflation Gauge



Sources: ANZ, Statistics NZ

Net Implied Margins PPI
Ag/Forestry/Fishing (Outputs - Inputs)



Sources: ANZ, Statistics NZ

Farm input inflation continues to track higher than headline inflation in NZ, largely due to higher livestock values. The next read on farm inputs will be at the end of February, where the rate of increase is expected to be lower, following headline inflation pressures continuing to undershoot expectations, and store stock values having collapsed in the sheep and beef sector.

Annual headline inflation for Q4 2012 edged up to 0.9 percent, the third successive reading at or below 1 percent. Non-tradable prices rose 0.3 percent in Q4, consistent with the directional signal provided by our Monthly Inflation Gauge, but weaker than the RBNZ pick. Largely due to a 1.8 percent fall in food prices, tradable prices fell 0.7 percent. **Elsewhere, the patchy retail demand environment and high NZD continues to temper price increases.**

Distributional measures also confirmed a benign pricing environment, with the proportion of items experiencing price increases easing to 43.2 percent, the lowest in the history of the series. Similarly, the proportions of items experiencing price falls rose to 43.1 percent, a record high. There are also signs of downward pricing pressure being exerted on non-tradable prices, with the weak labour backdrop and lower tradable prices as potential contributors.

All-in-all, a more benign inflation environment and farmers maintaining a tight rein on expenditure should allow farm budgets some breathing room on the cost side of the ledger in 2012-13 and heading into 2013-14.

Margins remain under pressure. A continuation of the high NZD, with only a modest turnaround of in-market commodity prices, have seen primary producer index (PPI) margins (the gap between output prices and input prices) drop a further 2.2 percent q/q in September. This slowed the compression in PPI margins from 11.5 to 7.6 percent y/y, but in level terms **the aggregate measure for the primary sector slipped to its lowest level in three years.** Benign inflation pressures meant there was no change for inputs, largely due to the high NZD. However, the high NZD continued to place pressure on output prices, which were back 2.2 percent q/q.

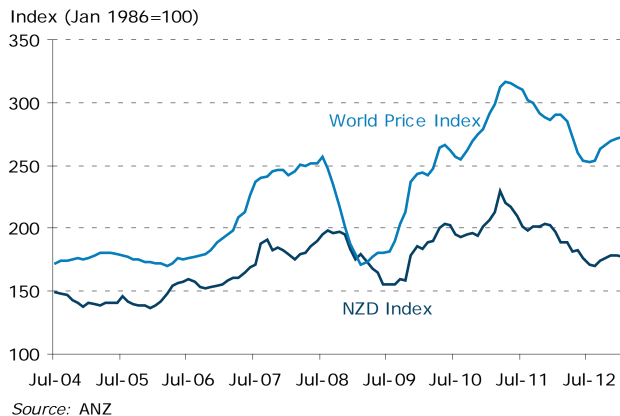
Dairying (-9.4 percent q/q) led output prices down, hitting their lowest level since the height of the GFC. **The changes in output prices of other sectors were more mixed,** with horticulture, fishing and aquaculture slightly down, but forestry, sheep and beef bucking the trend. This leaves annual net margins for dairying back 18 percent, and other livestock sectors back 5-6 percent. Forestry and horticulture fared the best, declining only 2.5 and 1.0 percent respectively.

ANZ

KEY COMMODITIES: OVERALL INDEX AND DAIRY

ANZ COMMODITY INDEX					
	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
NZ Index	177	178	197	↓	↓
World Index	273	272	290	↑	↓

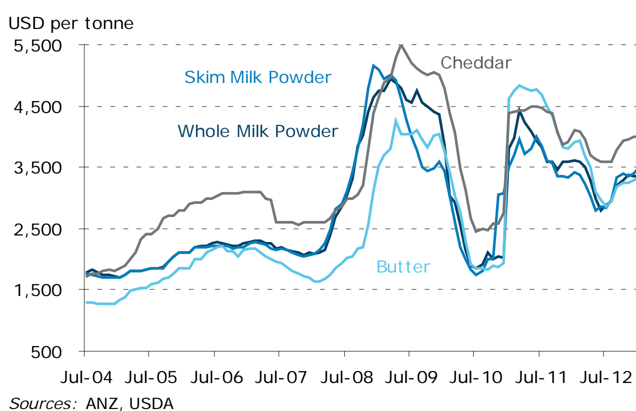
ANZ Commodity Price Index



Source: ANZ

OCEANIA DAIRY PRICE INDICATORS					
USD per tonne	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Whole Milk Powder	3,350	3,350	3,619	↔	↓
Skim Milk Powder	3,500	3,400	3,425	↑	↑
Butter	3,325	3,288	3,913	↑	↓
Cheddar	4,000	4,000	4,113	↔	↓
World Basket	3,544	3,509	3,767	↑	↓

Dairy Products - Oceania Export Market Prices



Sources: ANZ, USDA

The ANZ Commodity Price Index has continued to improve, with in-market price gains becoming broader based in recent months. With the NZD remaining strong though, in-market price gains have delivered only modest relief to farm-gate prices.

The global picture for soft commodity markets looks more positive heading into the first half of 2013. Support factors include the continued dry weather conditions over much of the US, mixed weather for other major exporters, low inventory levels of key grains, the continued weakness of the USD, and excess global liquidity flowing into soft commodities investments. However, the better outlook is conditional on the global growth outlook for the major economies holding together. While consensus forecasts point toward a slight improvement, recent downgrades highlight a number of uncertainties.

Dairy markets are expected to continue to strengthen in the first quarter of 2013. This is driven predominantly by the supply side of the equation. Production of dairy commodities and stock levels have generally contracted in the Northern Hemisphere, and export volumes coming out of both the US and the EU are now declining. A strong start to the first half of the NZ milk production season has helped to fill the gap in supply left by our competitors. However, milk production in NZ is now well past its seasonal peak and growth rates relative to the previous season are slowing due to dry conditions in the North Island. This is expected to result in a further contraction in global milk supplies before the seasonal lift in production in the Northern Hemisphere countries occurs in Q2 2013.

On the demand side, the flow of product continues to be toward China. In fact, total exports of our main dairy products to China have doubled over the last six months, compared with the same period a year before. At the moment in-market inventories are reported as satisfactory, but as these are worked through, re-stocking will add additional demand and further tighten markets.

While the currency remains a bugbear for all exporters, Fonterra's CEO Theo Spierings said in his December update that any movements in the NZD were 'neutral', implying Fonterra are fully hedged for the remainder of the 2012-13 season. This means price movements in the GDT auction will drive the direction for farm-gate pricing for the remainder of 2012-13. With year-to-date pricing around $5.30-$5.40 and **auctions during January translating into something close to $5.75 per kg MS, this suggests there could possibly be another $0.10-$0.20 upside to the $5.50 per kg MS by year-end if prices continue to strengthen.**

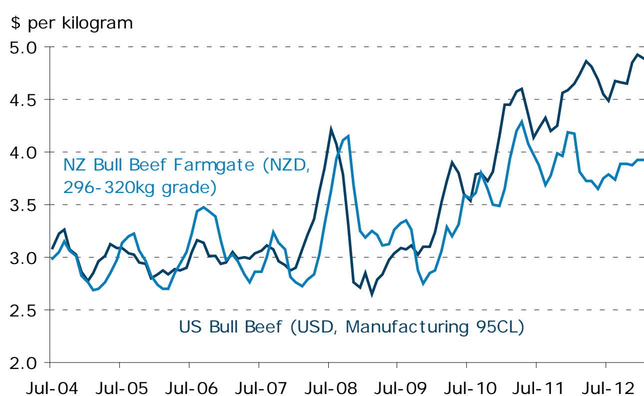
KEY COMMODITIES: BEEF AND LAMB

BEEF PRICE INDICATORS					
$ per kg	**Current Month**	**Last Month**	**Last Year**	**Chg. M/M**	**Chg. Y/Y**
US Bull Beef[1]	4.89	4.93	4.65	↓	↑
NZ Bull Beef[2]	3.92	3.92	4.17	↓	↓
NZ Steer[2]	3.89	3.90	4.14	↓	↓
NZ Heifer[2]	3.31	3.32	4.22	↓	↓

[1] USD, Manufacturing 95CL

[2] NZD, 296-320kg Grade Bull & Steer, NZD, 195-220kg Grade Heifer

Beef Indicator Prices

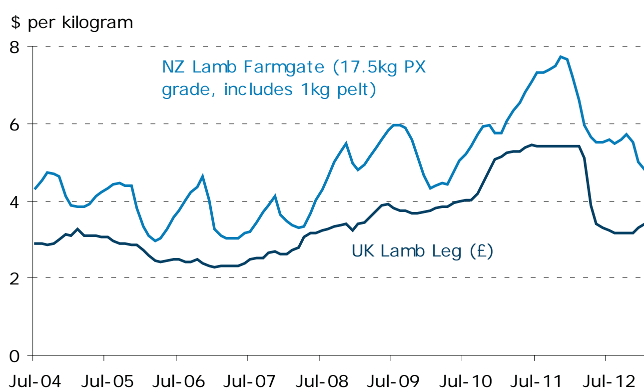


Sources: ANZ, Agrifax

LAMB PRICE INDICATORS					
$ per kg	**Current Month**	**Last Month**	**Last Year**	**Chg. M/M**	**Chg. Y/Y**
NZ Lamb[1] (NZD)	4.80	4.99	7.22	↓	↓
UK Lamb Leg (£)	3.40	3.29	5.42	↑	↓

[1] 17.5kg PX grade, including 1kg pelt

Lamb Indicator Prices



Sources: ANZ, Agrifax

The 2013 outlook for beef prices continues to look solid. Nevertheless, a range of factors could temper the traditional rise in prime schedule prices from January to May. Traditionally the US imported price improves during this period, but much of the US remains extremely dry, raising concerns of a potentially higher-than-expected cow slaughter in early 2013. If this eventuates, it will temporarily keep a lid on manufacturing beef prices. However, when the rain arrives, US beef producers will switch into herd rebuilding mode and look to retain cows. It is at this point prices are expected to post new records.

Additionally, **NZ is expected to experience a heavier turn-off of cull dairy cows in March/April,** especially if dry conditions persist in the North Island. This will reduce procurement pressure for meat companies and increase the supply of manufacturing beef. The other factor in the near term is the fact that large volumes of beef were imported into the US late last year, but demand for beef is reported to have been poor so far in January. This has been linked to reduced consumer spending power due to tax changes, as well as stiff competition from cheaper proteins. The weaker demand means US importers are generally adequately stocked and will not be topping up until the existing high-priced inventory has cleared.

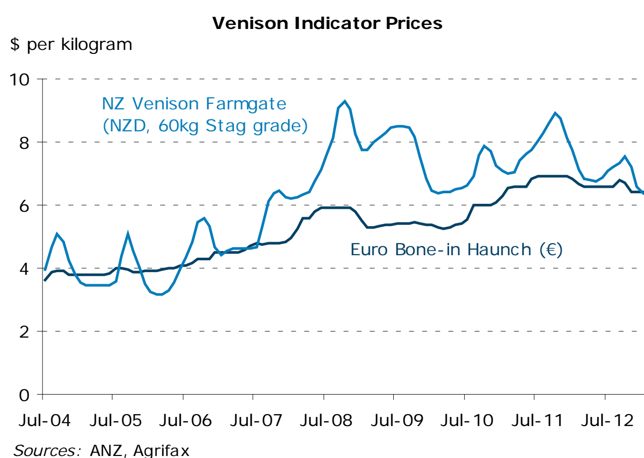
Lamb schedules look like they have bottomed around $4.70 per kg, but are not expected to improve substantially until the normal seasonal uplift in May/June. There have been mixed reports from overseas lamb markets. Prices for legs have improved, with signs the lower price levels are starting to stir up some demand compared with a year ago. China is reported to still be buying strongly, and flap prices have risen in January. China is also buying more products that in the past would have been destined for rendering plants, which all helps to add value to a carcass. Skin prices have stabilised further adding to co-products contribution to earnings. However, middle cuts – which make up a significant proportion of the carcass – remain under significant pressure, and prices in the US and Europe have been decreasing every week.

While NZ's lamb slaughter is running ahead of last year, an extra 1.6 million lambs born in the dry Spring conditions in the North Island mean it is still tracking 15 percent behind the five-year average. **Therefore while meat companies have been recovering some of last year's losses, they are not making great margins as there is still an element of local procurement competition to keep plants full.** In the short term, schedule prices will continue to hold firm until chilled processing for Easter finishes. **After the Easter trade to Europe has finished, and if dry conditions persist, then there could be a further drift lower before the normal seasonal uplift in May/June.**

KEY COMMODITIES: VENISON AND WOOL

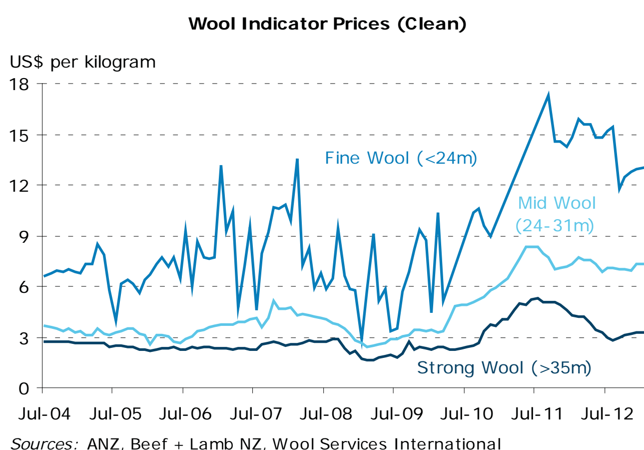
VENISON PRICE INDICATORS					
$ per kg	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
NZ Venison[1]	6.40	6.59	7.75	↓	↓
Euro Bone-in Haunch (€)	6.40	6.40	6.85	↔	↓

[1] 60kg Stag AP grade



Sources: ANZ, Agrifax

CLEAN WOOL INDICATOR PRICES					
$ per kg	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
NZ Fine Wool (>24m)	15.58	15.58	18.55	↔	↓
NZ Mid Wool (24-31m)	8.81	8.77	9.17	↑	↓
NZ Strong Wool (>32m)	3.94	3.92	5.32	↑	↓
USD Fine Wool (>24m)	12.98	12.95	14.84	↑	↓
USD Mid Wool (24-31m)	7.34	7.29	7.33	↑	↑
USD Strong Wool (>32m)	3.28	3.26	4.26	↑	↓



Sources: ANZ, Beef + Lamb NZ, Wool Services International

Venison prices have declined – as is usual for this time of the year – but pressure on higher value cuts and the high NZD mean they are tracking behind the last two years. Schedule prices during January seem to have bottomed at $6.40 per kg, down from $7.75 and $7.05 in the last two years.

Year-on-year production has been remarkably stable, with the number of animals slaughtered unchanged for the 2012 calendar year and the average carcass weight up just 0.3 percent. The Christmas chilled venison season has been reported as going reasonably well despite Europe's many challenges. Stable supply has ensured chilled venison prices have held relatively steady, though there is pressure on some higher-value cuts, such as strip loins, which are 25-30 percent above prices for European-sourced product.

The focus now moves to the frozen venison market, where indications are for a slight downturn. This already seems to have been reflected in NZ schedule prices. Cheap Spanish product as well as a large wild boar population in Germany, are both expected to contribute to the slight downturn in frozen prices. **All-in-all, prices seem to have bottomed, but are expected to continue to track slightly behind the last two years over the first half of 2013.**

Wool prices fell in late January after a strong start to the New Year, driven mainly by demand from Chinese customers seeking quick delivery. Prices eased at the latest combined North and South Island auction as the shipping pressure came off with reductions ranging from 1-5 percent across a range of wool types. There was some seller resistance to the falls though, with 13 percent of the almost 17,000 bales on offer passed in for failing to meet reserve prices. For the year-to-date, **total wool exports are up 17 percent. China continues to take the lion's share** (47 percent). Surprisingly, the share of exports going to Europe held its own. **Exports to the UK and Germany improved, but Italian exports have dropped by 10 percent.** This has seen China's share of fine wool exports increase to 70 percent.

The price competitiveness of wool versus cotton has improved over the last month. Cotton prices increased by 10 percent in January on concerns output from the US will drop as farmers choose to grow soybeans rather than cotton. The latest estimate is that the US will reduce the area planted in cotton by 16 percent this coming season. Stronger cotton prices will help wool, but they are not expected to reach the heights of 2010-11, as global stocks – especially in China – remain historically high.

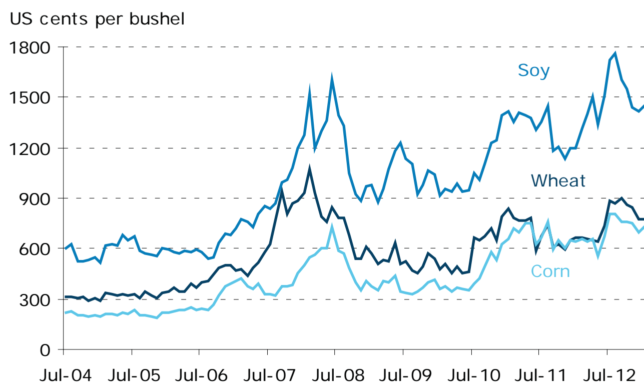
ANZ

KEY COMMODITIES: GRAIN AND FERTILISER

GRAIN & OILSEED PRICE INDICATORS					
USD cents per bushel	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Wheat	7.8	7.8	6.7	↓	↑
Soy	14.5	14.2	12.0	↑	↑
Corn	7.3	7.0	6.4	↑	↑
Australian Hard Wheat[1]	352	357	265	↓	↑

[1] NZD per tonne

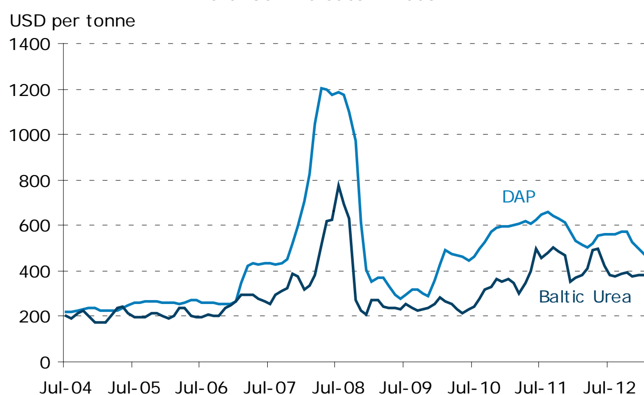
CBOT Future Grain & Oilseed Indicator Prices



Sources: ANZ, Bloomberg

FERTILISER PRICE INDICATORS					
USD per tonne	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
DAP	475	499	530	↓	↓
Urea	380	379	368	↑	↑

Fertiliser Indicator Prices



Sources: ANZ, Bloomberg

Global grain markets have rallied again as the fundamental pressures of low stocks and weather conditions have come back into focus. The US drought is now being called the worst since the 1930s dustbowl, and has caused widespread damage to winter crops, in particular the hard red winter (HRW) wheat. The main HRW wheat states have been very hard hit, in particular Kansas, where around 39 percent of the US HRW wheat is grown. Around 80 percent of the state has extreme drought, or worse. Ethanol production could also be set to rise after the dismissal late last year by US governors of the proposal to reduce the existing US ethanol mandate, and the recent upward movement in oil prices. Elsewhere, in Argentina, the world's second largest exporter of corn, wet weather delayed planting with over one third of the Argentine corn crop planted late in December. Conditions have subsequently turned dry, increasing fears of lower yields as the crop has emerged late.

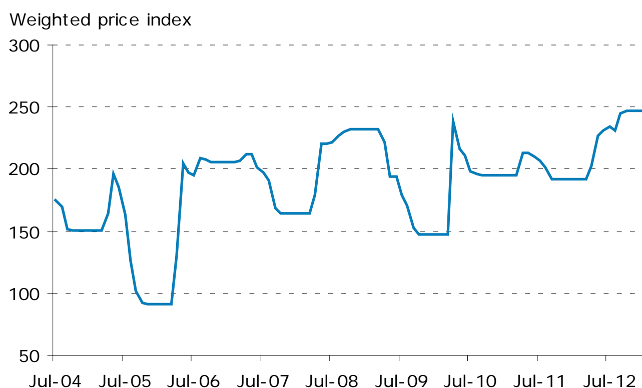
Domestic grain markets are quiet as a Mexican stand-off has developed between buyers and sellers. For new season crops many buyers are looking to fix prices lower than last year, but growers are not willing to meet the market as dry conditions in the North Island have developed. The start of the barley harvest in January has not put any pressure on prices, as space for barley in storage does not appear to be an issue yet. This has meant no large increase in sales clearing silos for the 2013 harvest. However, reports in Canterbury are that some farmers have been receiving better-than-expected yields and did have to clear some silo space. If storage pressure is to eventuate and put pressure on sellers it is most likely to come about in mid-to-late February when the wheat harvest is in full swing as there is still wheat in storage. Either this, or further deterioration in pasture conditions, seem to be the two catalysts that will end the current Mexican stand-off one way or another.

Fertiliser prices have generally been stable over the last 6-12 months. Softness is expected in the first quarter of this year. At the end of last year there was a lull generated by reduced end-user demand and inventory destocking. Many large consumers took the opportunity to liquidate excess fertiliser inventories. The liquidation of inventory is expected to continue in the short term as buyers defer purchases in anticipation of lower prices as new capacity is due to come on stream. **However, as Northern Hemisphere planting for the new season starts to get underway, demand and restocking will pick up lifting prices once again.** The US is expected to set the tone of this up-tick as long as the dry conditions dissipate by then. The US is expected to plant a very large crop in response to low inventory levels and high prices for all grains and other feedstocks.

KEY COMMODITIES: HORTICULTURE

HORTICULTURE PRICE INDICATORS					
	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Kiwifruit (USD per kg)	3.2	3.2	3.0	↑	↑
Apples (Weighted Index)	247	247	192	↔	↑
Wine (USD per litre)	5.9	5.7	5.5	↑	↑

Sources: ANZ, Zentrale Markt- und Preisberichtstelle



Sources: ANZ, Zentrale Markt- und Preisberichtstelle

Sources: ANZ, NZ Winegrowers

New Zealand wine volumes in the five months to November 2012 have declined 2 percent compared with last year. Specifically, bulk white wine exports have declined by nearly 20 percent, whereas packaged white wine has actually risen by 10 percent. **This has largely been due to a reduction in white volumes from the smaller 2012 vintage.** The contraction of bulk exports has come about as wine companies could see they were likely to have to move more wine through bottled product.

The average export price has thus improved by 7 percent to $6.50 per litre compared with the same period a year before. This has been largely due to a better bulk white wine price, which has averaged $3.56 per litre for the five months to November 2012. This is up $0.80 per litre (+30%) on the same period a year ago. **Falling bulk wine exports as a proportion of total exports have also contributed.** Bulk wine exports made up 31 percent of total exports in the five months to November 2012, compared with 38 percent over the same period a year before. The price of packaged white and red wine has been remarkably stable comparing the same periods. Only $0.05 per litre has separated the price of packaged white wine between the last two years, despite a 10 percent lift in packaged exports this year and a stronger NZD.

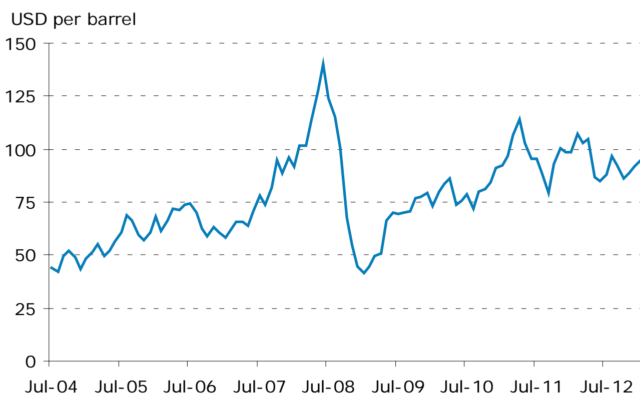
Overall, the 2013 vintage looks like it will be a barely average crop. Yields across Marlborough are being reported as variable, from poor flowering last year, grass grub and frost hitting certain areas. **Despite variable yields the quality is expected to be exceptional. Contracted Sauvignon Blanc grape prices on offer for 2013 range from $1,450 to $1,650 per tonne. Other white varieties such as Riesling and Pinot Gris continue to attract strong interest from wineries looking to fill orders.**

In the kiwifruit and apple sectors the focus is on the size and quality of upcoming harvests. In the kiwifruit sector expectations are for a further decline in the size of the Gold crop to 12-13 million trays, nearly half the average from the last five years. With 70 percent of NZ's kiwifruit area now infected with Psa, and regrafting having occurred for some vines, the green crop is also expected to be smaller this season. This will again tighten supply and put upward pressure on prices. So far the pass through of higher prices to retail seems to have been limited, but this is expected to change with this year's harvest. Higher retail prices will no doubt test demand.

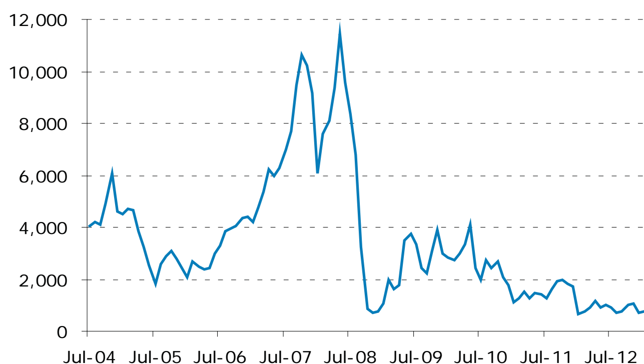
KEY COMMODITIES: OIL AND FREIGHT

OTHER COST INDICATORS					
	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Crude Oil[1]	95	92	98	↑	↓
Ocean Freight[2]	779	699	680	↑	↑

[1] USD per barrel, grade WTI
[2] Baltic Dry Index



Sources: ANZ, Bloomberg



Sources: ANZ, Bloomberg

Our forecasts have Brent oil rising 5.3 percent in 2013 to an average USD118/bbl and WTI rising 4.7 percent to USD99/bbl. Improved sentiment towards risk assets (against the backdrop of loose global monetary policy and improving economic conditions) should continue throughout the year. Prices could move higher in the second quarter from additional supply issues and tighter market balances compared to 2012.

Oil demand growth is forecast to improve by 2 percent in 2013 to an average 91.4mbbls/day. Better demand in the US and China should offset stale growth in Europe and India. China's crude imports and strategic stockpiling will continue to strengthen due to low replacement supplies in maturing domestic oil fields and lack of new discoveries. **Brent prices will be driven by Saudi Arabia's supply response and ongoing Middle East tensions. OPEC supplies should rise this year in line with demand, but Saudi Arabia has proven flexible in its supply response so far and will likely continue to exercise supply discipline.** The geopolitical risk premium is likely to be closer to USD10-15/bbl this year, slightly lower than last year. Markets will keep an eye on Iran though. A return of oil supplies if sanctions are removed could mean some of this risk premium is removed quickly. Outside Iran, the greatest risks to supply in 2013 will be posed by Libya, Algeria and Nigeria (although Nigeria's supply issues are ongoing). Output from Sudan should return to the market after coming to an agreement over the sharing of revenues, but could take some time. Iraq has potential to supply more to the market, but supply will be at risk from conflicts.

The Baltic Dry Freight index experienced a sharp drop in December. A substantial fall in Chinese iron ore imports had been anticipated in January after iron ore imports reached record levels in December. Steel mills have also built steel yard iron ore stockpiles up to around 32 days of cover, from 26 days in November. An ample level of cover in the Chinese steel industry is considered to be around 30 days.

Steel mills have also reportedly been buying a higher level of cheaper domestic iron ore, with the ratio use increasing to 84/16 from 80/20 (domestic/imported ore) in the past month. Reports the Chinese steel industry operated at a -0.18% EBIT margin for 2012 mean it's not surprising participants are chasing cheaper domestic supply. That said, freight rates are likely to pick up as Chinese iron ore imports improve in the second quarter, as further government stimulus and improving economic data confirms a better China growth outlook.

BORROWING STRATEGY

SUMMARY

While the floating rate has been stable, wholesale term interest rates have risen by around a quarter of a percent since our last *Agri Focus* was published. While this does make fixing relatively less attractive, with less than 0.7 percent separating the lowest and highest interest rates, the reality is that the decision to fix depends more on one's appetite for certainty. We expect to see floating rates rise eventually, and fixing some debt for 1-2 years now has some appeal. But with OCR rises some way off, time remains on the side of borrowers.

OUR VIEW

Indicative rural fixed rates have risen in the two months since our last Agri Focus was published. This move has coincided with an improvement in sentiment across global markets, a further rise in Auckland house prices, and greater confidence that the Christchurch rebuild is gathering momentum. We have also seen increased media chatter that "now is the time to fix", which has contributed to a mild pickup in fixing activity by homeowners, adding to upward pressure in the local market.

However, the floating rate has not changed significantly, and **with OCR rises some way off, we prefer to take a cautious approach when it comes to fixing, recognising that (a) RBNZ hikes are likely to be some way off; and (b) global challenges remain, and we may well see another bout of negativity.** Of course, the OCR will eventually rise, so at some stage there will be merit in fixing. However, as we see scope for floating rates to remain low for some time, and for global interest rates (which tend to have more of an influence on term rates) to come down, we prefer to take a patient approach, using spikes lower in interest rates to add to fixed cover.

Fixing is, and never has been without its risks, and the simple fact that fixed rates are above floating rates suggests that one ought to consider the choices very carefully, weighing up the costs against the benefits. Broadly speaking, **we would assess any decision on the basis of two criteria: (1) financial; and (2) qualitative considerations – aspects such as certainty and risk appetite.**

As a general rule, the first part of the analysis – crunching the numbers – is the easy part. There are a number of ways to do it, and **our preferred method is via breakeven tables,** which show where rates need to be in future for a particular decision to work out better or worse in the long run. Having calculated the breakevens, you are then left with the question – how quickly might interest rates rise, which is where the second consideration starts to come into play. One then needs to weigh up other factors such as certainty.

At the moment, breakeven numbers for all future periods increase steadily as one moves forward in time. For example, the 1 year rate needs to move from 5.73% now to 6.05% in 12 months time for one to be indifferent to being fixed for 2 years at 5.89%. That's a rise of 0.32%, which while not large, is not impossible given that by the end of the year the market will be focussing on OCR increases in 2014.

Rural Lending Rates (incl. typical margin)		Breakeven rates in			
Term	Current	in 6mths	in 1yr	in 2 yrs	in 3 yrs
Floating	5.68%				
6 months	5.69%	5.76%	5.97%	6.31%	6.57%
1 year	5.73%	5.87%	6.05%	6.39%	6.64%
2 years	5.89%	6.04%	6.22%	6.52%	6.79%
3 years	6.06%	6.20%	6.36%	6.66%	
4 years	6.20%	6.35%	6.51%		
5 years	6.35%				

Regardless of how quickly one believes interest rates might rise, the key point is that **one must believe that interest rates will rise in order to "profit" from fixing.** The question then becomes obviously, how quickly?

We do expect interest rates to gradually rise over time. On the face of it, this potentially suggests to a preference for fixing. However, the caveat is, we do not expect interest rates to rise aggressively, and we do not expect it to happen for some time. Furthermore, having just observed wholesale term rates spike higher since December, we see scope for them to correct lower given the still very uncertain global environment, the persistently high NZD, and the less than rosy outlook for jobs. Consequently, on the basis of the first consideration – the financial decision – we see merit in fixing a small portion of debt for 1-2 years. However, as OCR rises are some way away, **time is on the side of borrowers and there are likely to be opportunities to fix at lower levels before the year is out.**

Nonetheless, should one be inclined to fix, with less than 0.7 percent separating the floating rate from the longest fixed rate, **the incremental cost of fixing remains relatively low.** In essence, this "eases" the qualitative assessment as the trade-offs are not as steep. That is, if one has a hankering for certainty, the fact that it doesn't "cost" much means it's easier to pay up for it. If one is, for instance, seeking certainty and is not too concerned about the financials, fixing for 3 years costs less than 0.4% more than remaining floating. Some may find this attractive.

However, in our view, **borrowers still have time on their side, and we prefer to fix only a small portion of debt now, targeting better levels later.**

EDUCATION CORNER: CLIMATE CHANGE UPDATE

SUMMARY

As the sun sets on the first period under the Kyoto Protocol we thought it would be an opportune time to provide an update on the climate change agenda.

On the international scene, NZ has recently pulled out of a second commitment period under Kyoto. Those with binding commitments now encompass a very small proportion of global emissions, reducing its perceived relevance. It also lacks a compliance mechanism. Although, the New Zealand Government remains focused on achieving an "international, legally binding agreement by 2020", it is changing its strategy, preferring the UN Framework Convention stream that includes 85 percent of global emissions to achieve this. This framework has a much better chance of influencing policy and behaviour than a second commitment period under Kyoto, and our move provides us with a better chance of being inside the tent as opposed to outside when the real deals are being made.

On the domestic scene, there have been some recent amendments to the New Zealand Emissions Trading Scheme (NZETS) that will influence landowners' investment decisions. But in general the recent changes made have been designed to ensure the least amount of change to mitigate its impact on the New Zealand economy, which whilst improving, is still fragile. Transitional measures are being retained beyond their initial time limits, agriculture's entry is postponed further, the treatment of forestry is subtly tweaked here and there, and an offsetting mechanism has been included for pre-1990 forestry. A lot of the changes don't have an immediate impact on landowners, but will be influential in determining sectors exposures and responses at a latter date.

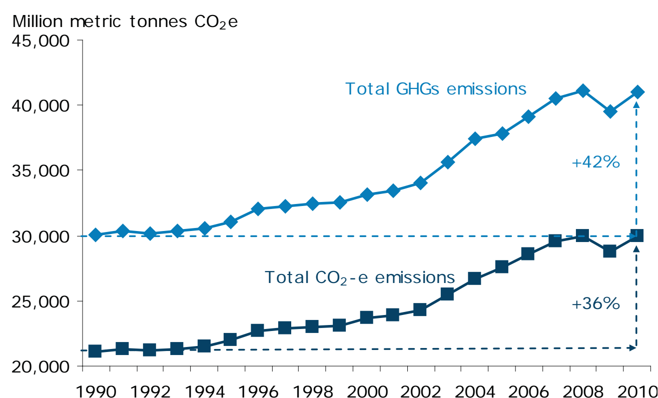
INTERNATIONAL SCENE

As we argued in our first update in November 2010 on the ins and outs of climate change, the setting and **ratification of an international agreement beyond 2012 is important for the New Zealand rural sector. This is because it will ultimately determine when and how carbon regulations will be imposed on methane and nitrous oxide emissions here.**

First up, some background. The Kyoto Protocol is an international agreement linked to the UN Framework Convention on Climate Change (UNFCCC). The major feature of the Kyoto Protocol is that it set binding targets for 37 industrialised countries and the European community for reducing greenhouse gas (GHG) emissions. These targets amounted to an average GHG reduction of 5 percent against 1990 levels over the five-year period 2008-2012. This period has subsequently been extended to 2015.

The major distinction between the Protocol and the Convention is that while the Convention encourages industrialised countries to stabilise GHG emissions, the Protocol commits them to do so. Recognising that developed countries are principally responsible for the current high levels of GHG emissions in the atmosphere as a result of more than 150 years of industrial activity, the Protocol places a heavier burden on developed nations under the principle of "common but differentiated responsibilities". **New Zealand's target was to reduce its GHG emissions to the level they were in 1990.**

The Kyoto Protocol had to be signed and ratified by 55 countries (including those responsible for at least 55 percent of the developed world's 1990 carbon dioxide emissions) before it could enter into force. This was achieved after Russia ratified in late 2004, with the Protocol entering into force on 16 February 2005. New Zealand ratified in December 2002. **Only countries that ratify the Protocol are bound by it.** Currently 191 countries have ended up ratifying it. The US signed, but did not ratify and Canada pulled out at the end of 2012. **Those that did not have binding commitments gave general commitments to reduce GHG emissions.**



Sources: ANZ, IPCC, UNFCCC, World Resources Institute

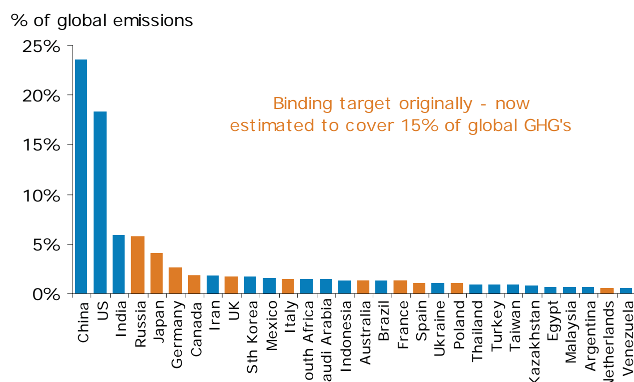
So what has been achieved with the sunset of the first commitment period under Kyoto? Well the first commitment period under Kyoto has in fact been rolled over to the end of 2015. However, we enter the **second stage with an estimated 40-50 percent more greenhouse gas being emitted globally** per annum than in 1990, as opposed to the reductions sought. Little wonder some are calling it a flop and ineffective. Such criticism is harsh considering some major emitters were always absent. With emissions running at current levels it illustrates that the biggest issue remains the rapid economic and population growth in the past two decades in emerging nations, most obviously China, who never signed up to the Kyoto protocol.

EDUCATION CORNER: CLIMATE CHANGE UPDATE

However, the reduction of GHG emissions was not Kyoto's only goal. It has effectively set up and developed a framework and mechanisms for dealing with the many different aspects of reducing emissions. This includes common accounting measures across a range of sectors, through to the establishment of different carbon markets and other market mechanisms to price emissions. The body of knowledge and expertise on climate change and other various aspects needed to reduce carbon emissions, such as policy and economics, has been consolidated and improved. Legislation and policy has been crafted and enhanced with this improved expertise and knowledge. **In essence, Kyoto has achieved a number of other goals, despite failing on its primary goal.** So while it can be labelled as ineffective at reducing global emissions between 2008 and 2012, it has laid down the groundwork for this to occur later down the track by establishing many of the mechanics and knowledge that will be required to achieve the lofty goal of reducing human-induced GHGs.

The Protocol has always been contentious. Opponents deny the science of climate change and claim the treaty is a socialist plot. Others argue it does not go far enough, decrying its lack of ambition and warning of dire consequences for future generations. **We side more with the latter. Addressing such issues – or at least being seen as parties to progress – is a key element of supporting our position in the international community and supporting the "clean/green" brand of New Zealand.** New Zealand champions a clean green image, and prioritises extracting maximum value out of that image in terms of the prices obtained for our products. It would be deeply cynical – and reputationally highly risky – to then ignore the brutal reality of climate change, and not be seen to play our part in finding solution.

Top 30 countries for global carbon emissions (CO_2 only and excluding LULUCF)



Sources: ANZ, United Nations Statistics Division

One issue the Protocol now faces is that since its adoption, the signatories with binding reduction targets share of global GHG emissions has fallen from over 60 percent to nearly 15 percent. This, combined with it not having any compliance mechanism, have become its two main weaknesses.

Originally, the treaty did not prescribe a mechanism for member countries to reduce their emissions. This was left up to each government. So if you didn't reach your target there was no one who could make you square your liability, or force you to write out a cheque to the international carbon market. However, **while it is impossible to make international law that is completely binding, it is not impossible to create something with teeth. The binding dispute settlement process of the WTO,** through which our apple growers have recently regained access into Australia, is a case in point. It's not perfect – settlements can be delayed for years if not decades – but it has notched up some notable successes. T**his dispute settlement process for trade issues did not come about overnight, and was preceded by other international law that was not effective at enforcing compliance for trade disputes. It is likely that the Kyoto Protocol will be looked upon in a similar light in years to come.**

Still, these weaknesses and political posturing are key reasons why New Zealand has opted out of a second commitment period under Kyoto. The move to the Convention stream appears to provide New Zealand with a better chance of being inside the tent as opposed to outside when the real deals are eventually made. Despite our small stature, international negotiations are one arena in which New Zealand punches above its weight. Climate Change minister Tim Groser maintains that the UN Framework Convention, which covers approximately 85 percent of global emissions, has a much better chance of influencing policy and behaviour than a second commitment period under Kyoto.

In terms of maintaining international credibility and a commitment to GHG reductions, our country is also one of the few to be on-target to meet our emission reduction requirements for the first commitment period to December 2012. According to the Ministry of Primary Industries, the latest projection for New Zealand's net position under the Kyoto Protocol is a surplus of 35.1 million units. This is largely due to the forestry plantings that occurred during the mid 1990s and the Global Financial Crisis reducing economic activity – and by default, emissions. Nevertheless, **this provides New Zealand with additional credibility with those who matter, in forming a new agreement post-2015. Other signs of our allegiance include the Government committing to the three-year extension of the first commitment period out to 2015 and the continuation of the NZETS and recent amendments to the legislation.**

EDUCATION CORNER: CLIMATE CHANGE UPDATE

All the handwringing and gnashing of teeth (or back-slapping if you are in the other corner) that occurred when the announcement was made New Zealand had pulled out of Kyoto's second commitment period, failed to appreciate these nuances. **The assumption that New Zealand was walking away from its commitments and preparedness to do something about climate change is not true.** The New Zealand Government still remains focused on achieving an "international, legally-binding agreement by 2020".

For landowners and farmers, maintaining credibility and influence at the global level is important, as it could allow New Zealand to get a separate work stream for agricultural emissions, (similar to the treatment of forestry), as opposed to being lumped in with fossil fuels. This would provide a number of benefits to recognising biological emissions as different to fossil fuels.

While there is a lot of uncertainty about what the successor to Kyoto will look like, more clarity is likely to emerge over the next few years. Ultimately, reaching an effective agreement will require the US to commit first to domestic action to limit its emissions, and then reach an agreement with China. These two nations alone would capture some 42 percent of human-induced GHG emissions and provide momentum towards a global agreement. If something cannot be agreed on, then New Zealand will find other ways to play its part – either signing up to another extension of the first Kyoto commitment period, and/or further integrating the NZETS with the Australian model, to form a regional platform. **The US and Australia remain the two key international countries to watch over the next several years.**

DOMESTIC SCENE

On the domestic scene there have been some recent amendments to the NZETS that are important and will influence landowners' investment decisions. But, in general the recent changes made have been designed to ensure the least amount of change. Transitional measures are being retained beyond initial time limits, agriculture's delayed entry is postponed further and the treatment of forestry is being subtly tweaked. Added to these small tweaks are the inclusion of a pre-1990 offsetting mechanism, different treatment for synthetic gases and a new levy mechanism to address vehicle imports.

Effectively, the Government has sought to mitigate the impact of the legislation on the New Zealand economy while still providing some credibility in the international arena for climate negotiations. The changes help to avoid any further cost on taxpayers in the interim – not that we expect the Government to be writing out a cheque to the international carbon market any time soon.

So what are some of the tweaks for landowners?

For farmers, the Government has decided to indefinitely postpone the sector's liability to surrender carbon credits for agricultural (methane and nitrous oxide) emissions. Previously these gases had been due to be included in 2015, but it is now delayed until a future government goes through the process of amending the Act again. Climate Change Minister Tim Groser was quoted in December 2012 saying: "So is this a great time to put new costs on our major exporting industry when we have a huge need to increase our exports? The Government does not think so. Not a single country in the world has put a price on 'biological emissions'. Our agriculture sector is, by and large, the most carbon efficient agriculture sector in the world. However because we produce so much for export, emissions from this sector are high. Other less efficient agricultural economies would create more emissions for the same or less output".

While the other two main political parties have a different take on things, this line of argument, along with the fact that Australia, Europe, and the US are highly unlikely to include agricultural emissions, means agriculture's inclusion in the NZETS is going to be parked for some time.

Of perhaps more relevance to farmers is that while the liability is parked, different sectors' obligation to report agricultural emissions remains. This obligation to report became compulsory in 2012 for processors of meat, dairy, and fertiliser, as well as live animal exporters. Wool processors and egg producers have been excluded for practical and compliance cost reasons.

The recent amendments also include a change from a bottom-up methodology of accounting for agricultural emissions to a top-down approach. The changes are along the lines of what sector representatives have recommended over the past several years.

The changes were made for three major reasons:

1. The previous approach for calculating agricultural emission factors in the ETS was overly complex, lacked transparency, and relied on multiple assumptions, which were difficult to follow and verify;
2. Emissions were misallocated between the beef and dairy cattle sectors; and
3. All emissions from sheep were placed on meat at slaughter and none on wool.

EDUCATION CORNER: CLIMATE CHANGE UPDATE

Key changes include a single, per tonne emission factor, replacing a two-part calculation on slaughtered livestock.

Emissions are assigned to dairy and beef products on the following basis to overcome the misallocation between the two sectors:

- All cattle face the same emissions charge per tonne of carcass weight at slaughter;
- All dairy herd emissions are placed on processed milk solids, except for those assigned to cull dairy cows;

Calves and vealers are exempt as they produce little or no emissions, but any emissions that they do produce are spread across slaughtered adult cattle and processed milk. The exemption of calves and vealers avoids any perverse incentive to cull these animals on-farm.

Sheep follow a similar approach that includes:

- Sheep emissions are assigned to both meat and wool (see table over the page). This recognises that meat and wool are separate industries and source their product from different farms.
- The emission factors for sheep meat are the same as those for cattle meat (i.e. 12.7 tonnes CO2-e per tonne of carcass weight). This is consistent with findings from recent greenhouse gas foot-printing studies, which show that sheep are as emissions efficient as cattle per kilogram of meat produced.
- The remaining sheep emissions are assigned to wool production. These emissions will be borne by the government, until a suitable point of obligation is found for wool production. Due to administrative and practical issues, wool production has been excluded.

The same methodology as described above is used for goats, deer, pigs, and poultry. For live animal exports, emission factors are calculated on a per animal basis, with fewer categories, for ease of reporting. The per animal emission factors are comparable to the per tonne emission factors for slaughter.

This new approach aligns more closely with New Zealand's Greenhouse Gas Inventory (the Inventory) reported under the Kyoto Protocol. This is what New Zealand is measured against for progress on its international obligations. The previous bottom-up approach over-estimated the emissions for the beef sector by approximately 2 million tonnes of CO2-e per year and under-estimated emissions from the dairy sector by approximately 2.6 million tonnes CO2-e per year. It also over-estimated emissions for sheep by approximately 1 million tonnes per annum. These issues are not evident with the new top-down approach.

Overall, the new approach has the following impacts, showing why the changes will matter for farmers if agricultural emissions are included in the NZETS at a future time:

1. **Emissions for the dairy sector increase by approximately 26 percent;**
2. **Emissions for the beef sector are reduced by approximately 24 percent;**
3. **Emissions for the sheep meat sector are reduced by approximately 40 percent,** with the main reduction coming from the Government's move to exclude emissions related to wool production (approximately 30 percent of sheep emissions) until a suitable point of obligation is found for wool.
4. **Emissions for venison increase by 20 percent;**
5. **Emissions for pork, goats, and poultry reduce by 45 to 55 percent.** For pigs and poultry, reductions are primarily due to recent updates to the emission factors in the Inventory rather than improvements to the approach for calculating emissions in the ETS.

Overall the new approach is an improvement, in that it:

How emissions are assigned to dairy, beef and sheep products using top-down approach

Outputs	Dairy Sector		Beef Sector				Sheep Sector	
	Milksolids	Cull Cows	Cows	Heifers	Steers	Bulls	Lamb & mutton	Wool
Quantity of Product (Mt)	1.3	0.1	0.05	0.12	0.19	0.17	0.55	
Emission factor per tonne product	8.5	12.7	12.7	12.7	12.7	12.7	12.7	
ETS emissions (Mt CO_2-e)	**11.1**	**1.3**	**6.8**				**7.0**	**4.0**
NZ Greenhouse Gas Inventory emissions (averaged 2004-2009)	12.4 MT CO_2-e		6.8 MT CO_2-e				11.0 MT CO_2-e	
Previous methodology estimates	9.8 MT CO_2-e		8.9 MT CO_2-e				12.0 MT CO_2-e	
Total ETS emissions = Σ(emission factor x tonnes of product processed)								

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- **Is transparent, robust, straight-forward, and practical;**
- **Uses calculations and assumptions that are easy to follow, robust and verifiable;**
- **Is consistent with emissions reported in the Greenhouse Gas Inventory;**
- **Resolves the misallocation of emissions between the beef and dairy sectors.**

There have been two other changes that affect farmers and landowners. One is the tightening of criteria around the eligibility of imported credits (ERUs, CERs and/or RMUs). Second is the inclusion of a pre-1990 offsetting mechanism for forestry owners who deforest. This change, along with the currently low carbon price, has increased the flexibility for pre-1990 and post-1989 forestry landowners who want to change to a different type of land use.

The offsetting mechanism allows landowners of pre-1990 forest who deforest to plant an equivalent or better forest of the same area elsewhere, without deforestation liabilities. This means suitable land, such as around Wairakei and the Central Plateau, can be converted to dairying without incurring carbon liabilities, as long as an equivalent area of forestry is established elsewhere.

However, establishing a forest elsewhere is currently probably more expensive than purchasing imported units, such as ERUs, CERs or RMUs, to surrender for the liabilities created from deforesting a pre-1990 forest. So while the carbon price remains low this will probably be the more attractive option, but when the carbon price eventually rises the offsetting mechanism will become more important for landowners who want to change their land use for pre-1990 forest. **The current low carbon prices also seem like an opportunity for owners of post-1989 forests who have claimed and sold credits at high prices to re-purchase those credits to eliminate any future liability. The same applies for post-1989 owners who want to get out of the NZETS.**

Where landowners have applied for, and received, approval to take up offsetting, they would be required to surrender or repay any second tranche NZUs they have received for the land being offset. This small amount of compensation was originally provided as partial compensation to pre-1990 forest landowners for the loss of land value arising from deforestation liabilities under the ETS. The introduction of offsetting from 2013 is expected to reduce both the impact of the ETS on pre-1990 land values and the cost of conversion. Pre-1990 forest land that is deforested with offsetting, and is later replanted, is also eligible to be registered as post-1989 forest land. Other practical changes include the relaxing of requirements to replant/restock land that has been cleared and left to regenerate to indigenous forest, or where poplars and willows are planted for erosion control.

While the price for NZUs might currently be low, as emitters have been able to import units from offshore, this won't always be the case. Indeed, recent amendments have included a tightening in the eligibility of imported units. In addition, because New Zealand has not signed up to the second commitment period under Kyoto we will not be able to acquire United Nations approved units (CERs or ERUs) from 2015 onwards to help balance the country's emission target.

The recent tightening in eligibility criteria included a ban on ERUs and CERs generated from industrial gas destruction projects and large-scale hydropower projects. These units were banned due to concerns about their environmental integrity. **The tighter policy regarding the use of such units essentially tries to strengthen the credibility of the NZETS and therefore the ability to advance discussions on linking with other major domestic trading schemes such as Australia, and building regional and bilateral linkages among carbon markets beyond 2015.** For emitters the downside is a reduction in the availability of different types of units to meet their liabilities and the additional compliance costs of verifying offshore units' credibility. Such changes again demonstrate the Government's commitment to pricing carbon and addressing New Zealand's carbon emissions.

UPSHOT

While the uncertainty around international negotiations on climate change continues and New Zealand has opted out of a second commitment period under Kyoto, don't think that carbon politics and policy have gone away. The Government remains very much committed to achieving a new international, legally binding agreement and we think it is in New Zealand's best interest to be at the table. Ignoring the basic realities of climate change is inconsistent with New Zealand's strong branding position.

For now it is business as usual, with most of the transitional measure in the NZETS extended. However, don't forget there are a number of proactive steps that individual landowners can undertake now when making investment decisions that will place them in good stead for what the future might hold. These range from basic business best practices that improve energy efficiency and animal performance, through to smart investment, such as when undertaking riparian planting and erosion-control seeing if this investment can meet the definition of a forest under the NZETS, so one can receive carbon credits on top of an investment that has been made for other reasons.

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KEY TABLES AND FORECASTS

FX RATES	ACTUAL			FORECAST (END MONTH)						
	Dec-12	Jan-13	4-Feb	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14
NZD/USD	0.829	0.833	0.848	0.84	0.84	0.84	0.84	0.83	0.81	0.80
NZD/AUD	0.797	0.798	0.814	0.80	0.80	0.80	0.80	0.80	0.80	0.81
NZD/EUR	0.628	0.636	0.622	0.65	0.65	0.65	0.64	0.63	0.63	0.63
NZD/JPY	71.90	69.79	78.66	65.5	65.5	65.5	65.5	64.4	63.3	63.7
NZD/GBP	0.510	0.512	0.540	0.52	0.52	0.52	0.52	0.52	0.52	0.51
NZ TWI	74.4	74.4	76.3	74.5	74.5	74.4	74.3	73.3	72.7	72.4

INTEREST RATES	ACTUAL			FORECAST (END MONTH)						
	Dec-12	Jan-13	4-Feb	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14
NZ OCR	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.75	3.00	3.00
NZ 90 day bill	2.69	2.75	2.67	2.80	2.80	2.80	2.80	3.20	3.30	3.30
NZ 10-yr bond	3.52	3.57	3.77	3.50	3.60	3.80	3.80	3.90	4.20	4.40
US Fed Funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
US 3-mth	0.31	0.31	0.30	0.30	0.30	0.30	0.30	0.30	0.35	0.35
AU Cash Rate	3.00	3.00	3.00	2.75	2.50	2.25	2.00	2.00	2.00	2.00
AU 3-mth	3.07	3.03	2.93	2.90	2.70	2.40	2.20	2.20	2.20	2.20

ECONOMIC INDICATORS	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
GDP (% q/q)	**0.8**	**0.4**	**0.5**	**0.7**	**0.7**	**0.7**	**0.6**	**0.6**	**0.6**	**0.6**
GDP (% y/y)	**2.2**	**1.7**	**2.0**	**2.6**	**2.5**	**2.7**	**2.8**	**2.6**	**2.4**	**2.4**
CPI (% q/q)	-0.2	**0.5**	**0.5**	**0.5**	**0.2**	**0.7**	**0.7**	**0.7**	**0.2**	**0.2**
CPI (% y/y)	0.9	**0.9**	**1.1**	**1.4**	**1.7**	**1.9**	**2.0**	**2.3**	**2.3**	**2.3**
Employment (% q/q)	**0.3**	**0.2**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**
Employment (% y/y)	**0.1**	**0.0**	**0.4**	**1.1**	**1.1**	**1.3**	**1.4**	**1.4**	**1.4**	**1.4**
Unemployment Rate (% sa)	**7.1**	**7.1**	**7.0**	**6.9**	**6.8**	**6.7**	**6.6**	**6.5**	**6.4**	**6.4**
Current Account (% GDP)	**-5.1**	**-5.1**	**-5.1**	**-5.2**	**-5.3**	**-5.2**	**-5.2**	**-5.1**	**-5.1**	**-5.1**
Terms of Trade (% q/q)	**-0.4**	**0.1**	**0.3**	**0.5**	**0.3**	**0.3**	**0.3**	**0.3**	**0.2**	**0.2**
Terms of Trade (% y/y)	**-8.2**	**-6.0**	**-3.3**	**0.4**	**1.2**	**1.5**	**1.5**	**1.3**	**1.1**	**1.1**

Figures in bold are forecasts. Quarter-on-Quarter yoy: Year-on-Year

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NEW ZEALAND'S 20 LARGEST EXPORT MARKETS

NZ'S TOP EXPORT MARKETS FOR THE 12 MONTHS ENDED DECEMBER 2012 (NZ$M)

	Global Total	Australia	China	USA	Japan	Korea	UK	Germany	Malaysia	Hong Kong	Singapore	Indonesia	Taiwan	India	Saudi Arabia	Philippines	Thailand	UAE	Nether-lands	Canada	Venezuela
Sheepmeat	2,638	8	344	247	45	3	532	263	50	33	12		52		96	1	3	9	148	87	
Beef	2,079	17	51	911	196	120	29	17	27	42	48	43	134		8	41	11	23	31	99	
Other Meat	450	40	17	22	39	29	28	64	9	25	7	6	2		12	3	2		22	3	
Milk Powder	6,862	49	2,089	12	26	7			326	127	192	283	152	1	267	208	201	409	6		433
Butter	1,992	83	197	111	19	19	1		52	17	38	46	53	16	94	69	37	37	6	20	3
Cheese	1,453	227	94	52	310	124	29		31	17	9	61	28		82	56	14	17	25		5
Whey/Casein	1,976	55	263	766	211	48	4	154	30	2	62	38	13	6	26	26	2	1	7	34	11
Kiwifruit	1,075	66	116	25	318	64		195	15	31	10	8	95	3		2	6	3		4	
Apples	369		3	46	6		49	41	11	23	12	6	18	23		1	32	18	33	6	
Other Fruit/Vege	598	267	4	31	149	24	3	3	15	6	9	1	14	2		1	15	1	1	1	
Wine	1,218	382	30	270	14	2	290	9	3	20	15		1			1	2	6	28	74	
Wool	800	53	388	25	22	2	51	43	8	5		1	11	33			9		1	3	
Skins/Hides	567	19	209	3	10	24	5	2		35		10	4	11			11				
Logs	1,645		1,048		162	253							10	164			4				
Sawn Timber	1,120	330	163	160	82	51	1	2	15	1	6	22	36	3	26	58	30	10	9		
Fibreboard/Plywood	395	61	27	11	223	1			9	1		20	3	4		9	2			1	
Wood Pulp	589	60	176		75	74			20		6	85	23	12		4	26				
Fish/Seafood	1,482	280	336	137	133	46	11	19	8	118	28	4	7		1	3	24	5	6	14	
Crude Oil	2,027	1,851			33						89	24									
Aluminium	1,042	85	31	57	490	121	60	2	2	15	1	4	2	16			2		77	3	
Remainder	15,652	5,912	1,273	1,354	649	540	304	153	255	354	300	177	171	495	75	198	194	71	169	214	6
TOTAL	**46,027**	**9,847**	**6,862**	**4,242**	**3,211**	**1,551**	**1,396**	**966**	**887**	**870**	**845**	**839**	**829**	**789**	**688**	**679**	**626**	**612**	**570**	**565**	**459**

NZ MERCHANDISE EXPORTS ANNUAL CHANGE BETWEEN THE 12 MONTHS ENDED DECEMBER 2012 AND A 12 MONTH SPAN A YEAR EARLIER (NZ$M)

	Global Total	Australia	China	USA	Japan	Korea	UK	Germany	Malaysia	Hong Kong	Singapore	Indonesia	Taiwan	India	Saudi Arabia	Philippines	Thailand	UAE	Nether-lands	Canada	Venezuela
Sheepmeat	-374	-2	151	-56	-23	-2	-52	-51	-1	-8	-3		-7		-4	-1	-3	-2	-25	-37	
Beef	21	-1	39	113	10	-52	-10	-6	14	4	1	-59	1		2	1	4	3	-7	-20	
Other Meat	-10	11	7		-4	2	-3	-5	6	9		-11			3				-10	-2	
Milk Powder	-102	-37	337	-1	4	-12			-15	73	-41	32	-30	-77	-33	-77	-68	62	-3		-27
Butter	-496	-13	-18	-5	-13	-10	1		-10	-3	-13	-14	-21	2	-32	-7	-14	-7	-1	-5	
Cheese	88	-35	21	46	-12	10	-8		5	-2		11	-10		45	3	-3	-2	2		-6
Whey/Casein	225	-8	57	42	3	1	-1	35	12	-5	11	10		2	4	1		1	5	6	5
Kiwifruit		2	26	-3	16	-12		-34	2	2			20			1	1	-1	-1	2	
Apples	-1		2	4	6		2	-11	1	-2	2	1	-8	7			11	7	-20		
Other Fruit/Vege	-54	-44	1	-4	-7	2		-1	2			-1					2		-1	-1	
Wine	83	27	8	36	3		-4	3	1	1	1						1	1		10	
Wool	-115	-41	-8	2	3		-11		3	-3				-12			-1	-1		-1	
Skins/Hides	8	1	29		3	3	-1			-3		1	1	-14			4				
Logs	-97		21		-15	-62							-3	-36							
Sawn Timber	44	2	39	4	-11	1	-1				1	-4	1	-4	11	11	-3	3	6		
Fibreboard/Plywood	15	-5		-4	30				2			-1	-1		-2	3					
Wood Pulp	-88	-11	-26		-23	-16			-5		-5	-5		1		-4	-6				
Fish/Seafood	4	8	55	-19	14	4	-3	-6	-1	-28	-7	2	-2		-1	-3	-1	2	-2	1	
Crude Oil	-379	-504			10						89	24									
Aluminium	-200	-9	1	-14	-175	-3	3	1	1	4		1		-6			-1		-7		
Remainder	-247	-341	233	105	-47	23	-60	-5	-7	33	-3	-4	-12	-13	4	-6	-29	-12	11	15	1
TOTAL	**-1,675**	**-1,001**	**975**	**245**	**-229**	**-124**	**-148**	**-80**	**13**	**72**	**32**	**-17**	**-70**	**-149**	**-3**	**-78**	**-106**	**54**	**-55**	**-32**	**-27**

NZ MERCHANDISE EXPORTS ANNUAL CHANGE BETWEEN THE 3 MONTHS ENDED DECEMBER 2012 AND A 3 MONTH SPAN A YEAR EARLIER (NZ$M)

	Global Total	Australia	China	USA	Japan	Korea	UK	Germany	Malaysia	Hong Kong	Singapore	Indonesia	Taiwan	India	Saudi Arabia	Philippines	Thailand	UAE	Nether-lands	Canada	Venezuela
Sheepmeat	11	1	70	-4	-4		3	-13	3	-2			-1		-1		1	-1	-6	-4	
Beef	32	-1	23	52	-6	-1	1	-1	2	-1	-3	-18	-3		1	-1	2	1	-1	-5	
Other Meat	-7	4	1	-1	-2	1	1	-3	1	1		-4							-3		
Milk Powder	-257	-13	169	-4	2	-4			-11	32	-26	10	-15	-29	14	-31	-28	-25	-3		-195
Butter	-196	-12	-10	-7	2	-3	1		-5	-1	-5	-8	1	-14	-8	2	-8	-2	-4	2	1
Cheese	73	9	7	40	-6	8			2			8			15	-4		-2	4		
Whey/Casein	1	-8	14	-17		-5	-1	8	-1	-3	2			2		-2			-2	-1	
Kiwifruit	-13	1	-1		-4	-3			1	-1	-1		-5						-1		
Apples	1																1				
Other Fruit/Vege	-45	-38		-3	-4	-1		-1	1								1				
Wine	12	-2	2	6			5	2												-1	
Wool	-42	-9	-5	-1			-6	2					-1	-1			-1				
Skins/Hides		1	-5		1	2	-1			-3			1								
Logs	99		109		-2	1								-9							
Sawn Timber	6	2	15	-2	-4	-1			-1		-1	-1	4			3	-3	-2	3		
Fibreboard/Plywood	-6	-5	1	-1	1							-2				1					
Wood Pulp	-23	-2	-11		-11	-5			-2		-1	8		-1		-1	-2				
Fish/Seafood	-7	8	28	-4	-3		-1			-25	-11	1	-1			-2	-1		-1		
Crude Oil	-142	-165									18										
Aluminium	-42	-5		-3	-38	-6	7			-2				1					-1	-1	
Remainder	-176	-101	19	43	-69	1	-17	10	-16	-4	13	22	6	11	2	-12	-19	-7	7	-4	2
TOTAL	**-721**	**-333**	**425**	**96**	**-146**	**-16**	**-10**	**4**	**-27**	**-9**	**-14**	**17**	**-15**	**-41**	**23**	**-48**	**-57**	**-37**	**-8**	**-14**	**-192**

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