

A season of two halves

A primer on dry weather in New Zealand

- Drought has been declared in Northland. The rest of the North Island is also very dry.
- Dairy production growth is slowing rapidly after an excellent first half of the dairy production season. Overall, dairy production is likely to be similar to last season.
- Meat production is being brought forward as farmers respond to the dry conditions by culling stock earlier in the season than they normally would. This will result lower meat production next season as farmers rebuild their herds.
- The South Island is faring better with dairy production up strongly on last year. Also, hydro lake levels are near their average for this time of the year, indicating less risk to electricity production at this stage.
- Overall, the dry weather may take some gloss off what is otherwise shaping as strong growth during 2013. On balance, this is a negative for monetary policy and the currency.

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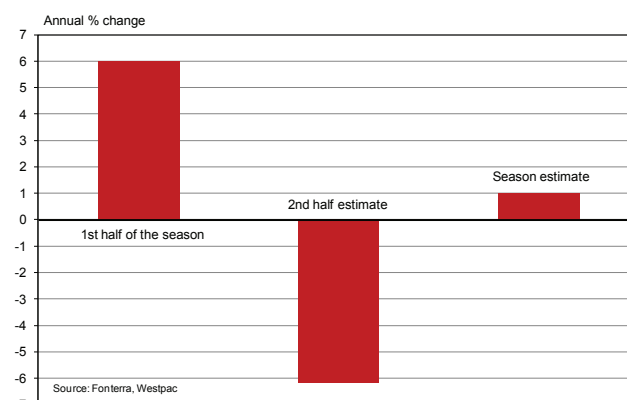
A drought has been officially declared in Northland, triggering the drought relief measures such as tax breaks for farmers in this region. The rest of the North Island is also very dry for this time of year, while the South Island is better, but still dry. The short-term weather forecast is not offering any respite. However, the forecast for March to May is for precipitation levels to return to normal.

...and dairy production is slowing rapidly

The dry conditions, particularly in the North Island, are hurting dairy production. After an excellent start to the dairy season (where milk collections were running around 6% higher in the season to December), Fonterra now estimates that collections for the whole season will be around 1% higher than last season. We agree with this estimate; it implies that over January to May period (which accounts for around 40% of production), milk collections will be around 6% lower than for the same period last season. Overall, it's shaping up as a season of two halves.

Dairy production is also a season of two islands, with the South Island faring better than the North. While the dry conditions are not as severe as in the North Island, better access to irrigation, particularly in Canterbury, and dairy farm conversions are also contributing to strong production growth. We estimate

Growth in Fonterra milk collections - 2012/13 season



that South Island production will be up around 10% compared to last season.

Meat production increasing intially, but payback will come next season

Farmers are responding to the dry conditions by culling stock earlier in the season than they normally would. As a result, meat production is likely to see an increase in the March quarter.

The payback will come later. Farmers will need to rebuild their herds. While they do so, they will send less stock to slaughter and meat production will fall accordingly. However, we expect this will be more evident next season (from the second half of 2013).

Overall, we expect agricultural production to make a below average contribution to growth over 2013.

The weather is the NZ economy's Achilles' heel

The weather matters for the New Zealand economy. In the five economic recessions since the Wool Bust recession in 1967 to 1969, drought has been a contributing factor.

New Zealand's pasture based farming system relies on rain to grow animal feed. While improved irrigation in some areas has reduced this reliance, rain remains critical to farming.

The economy also is susceptible to drought through the dominant role that hydro plays in the country's power generation. Hydro accounts for around 55% of New Zealand's power generation. The value-add component is also higher for hydro than for other forms of power generation such as gas. As such when lake

levels are low and hydro's share of power generation falls, the electricity sector's contribution to growth will also fall.

Hydro production less problematic

At this stage falling hydro production is less of a risk. Hydro lakes are at 94% of capacity for this time of year. Inflows, however, are at 70% of their average. Despite this, with lake levels where they are and long-term forecasts for precipitation to return to normal, we expect hydro production to make a positive contribution to growth over 2013.

We are watching nervously

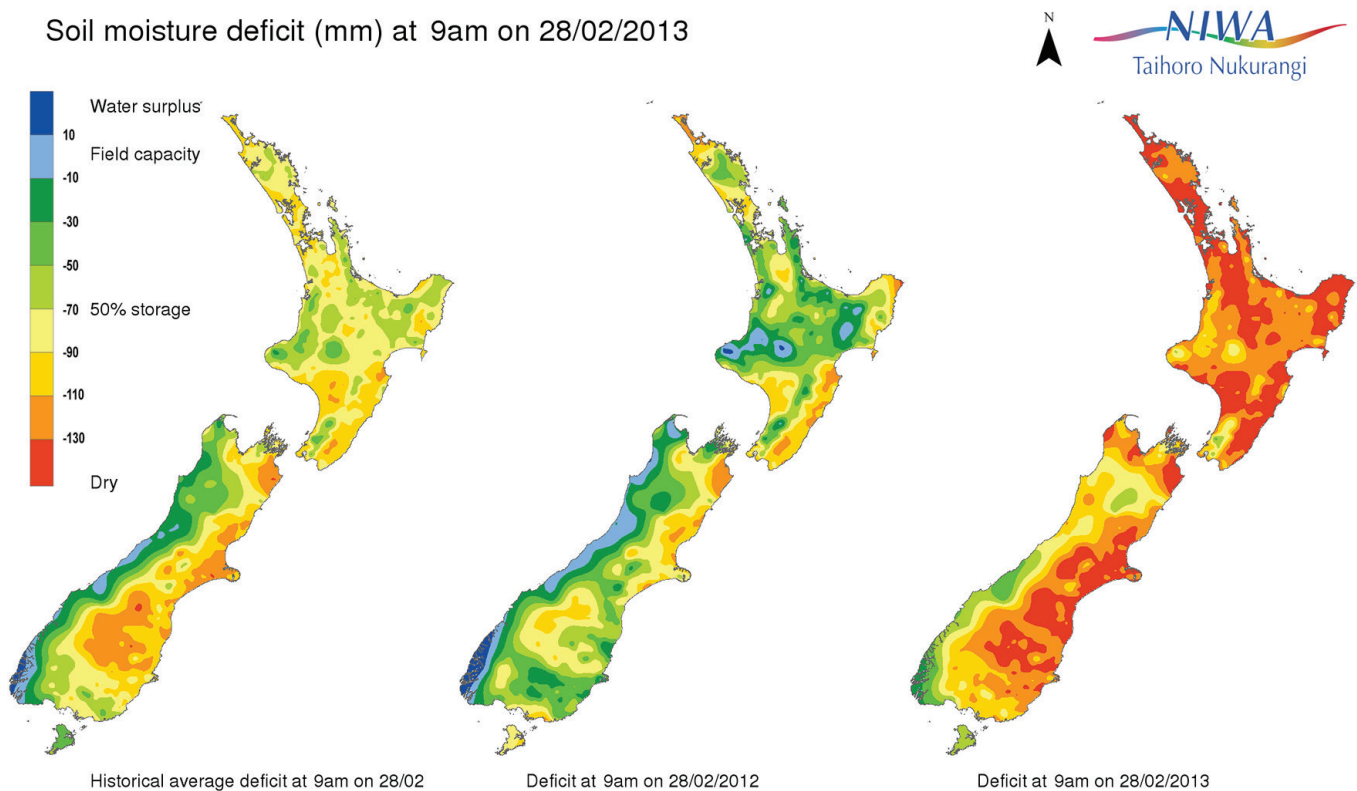
We are watching weather developments nervously. At this stage, we think that the dry weather will negatively impact GDP over 2013. That said, there are some prodigious offsetting positives in the Canterbury rebuild and heating housing market.

Overall, we still expect the New Zealand dollar to remain strong and the Reserve Bank to leave the OCR unchanged until December this year. The result will be an imbalanced economy favouring domestic demand at the expense of the export and import competing sectors.

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Annex:

Soil moisture deficit (mm) at 9am on 28/02/2013



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