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NZ drought pushes milk to record high

By Jack Farchy in London and Neil Hume in Sydney

International milk prices have jumped to a record high as Chinese buyers scramble for supplies amid a drought in New Zealand, the world's top exporter.

The price of milk feeds through into the cost of other dairy products, from cheddar cheese to clotted cream, which in turn helps to drive consumer price inflation.

Benchmark New Zealand milk export prices have surged 62 per cent since the start of the year to hit a record high this week on the back of the country's most widespread drought in 30 years. North Island, which produces most of New Zealand's milk, is suffering drought conditions, according to the government.

"Nearly all farmers in every part of the North Island are facing very difficult dry conditions," Nathan Guy, minister for primary industries, said last week.

New Zealand is the world's largest milk exporter, accounting for some 60 per cent of global trade in whole milk powder, the most widely traded form of the commodity, according to the US Department of Agriculture.

Tim Hunt, global dairy strategist at Rabobank, said he expected production in the final months of the current season to be 15-20 per cent lower than last year. "New Zealand has gone into a severe drought," he said.

At the same time, buyers in China, the world's top importer, have stepped up purchases, amid a harsh winter, which reduced domestic production, and rising consumption of dairy products as diets become richer and more westernised. Chinese milk imports in January had been about 70 per cent higher than a year earlier, Mr Hunt said.

At the most recent auction this week by Fonterra, the New Zealand co-operative that is the world's largest dairy group, prices of whole milk powder jumped 21 per cent to a record $5,116 a tonne. "There was a scramble to secure reduced New Zealand supply before the end of the season," said Con Williams, rural economist at ANZ.

The rise in prices will affect large importers of milk, such as China, most directly. But although big consumers such as the US and Europe are largely self-sufficient, rising international prices will spur an increase in prices as they make exports more attractive, Mr Hunt said.

"A rising tide lifts all boats. It will push up wholesale prices and lead to general upward pressure in retail markets."

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However, he cautioned that the impact on the retail price of dairy products was likely to be much smaller than the move in wholesale prices, with much of the increase absorbed by food companies.

"The economic environment, particularly in the EU, makes it extremely difficult to pass on price increases without seriously impacting your volumes in 2013," Mr Hunt said.

http://www.ft.com/intl/cms/s/0/915d8bc2-924c-11e2-a6f4-00144feabdc0.html#axzz2OU57SbKR

Outline

- **Commodity:** A type of good which is not differentiated based on qualitative factors, and hence has a more or less equal value across the world. (Ex: petrol, milk, coffee, etc.)
- **Supply-demand mechanism:** As the overall supply of good *x* decreases, this will create an excess of demand. As a result of this, there will be an upward pressure on the price as suppliers will realize the excess of demand and use this as a signal to increase the price.
- In this case, the commodity in question is that of milk, which is seeing a shortage of supply from the top producer in the world, New Zealand
- The decrease in supply comes due to a non-price factor, which is the environmental issue of a drought in North Island, NZ
- The problem that arises from this is that New Zealand's "milk export prices have surged 62 per cent"
- Since milk is a factor of production for many other goods such as dairy products, the prices of those have also taken a hike as supply shifts to the left
- China is the most affected, due to its location close to New Zealand, and a recent increase in demand related to recently increasing trends and culture of having a "richer and more westernised" diet
- Although retailers will see an increase in milk prices worldwide, wholesalers and food companies are expected to absorb most of the increase in costs

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Diagram 1: Shortage of supply - Excess of demand

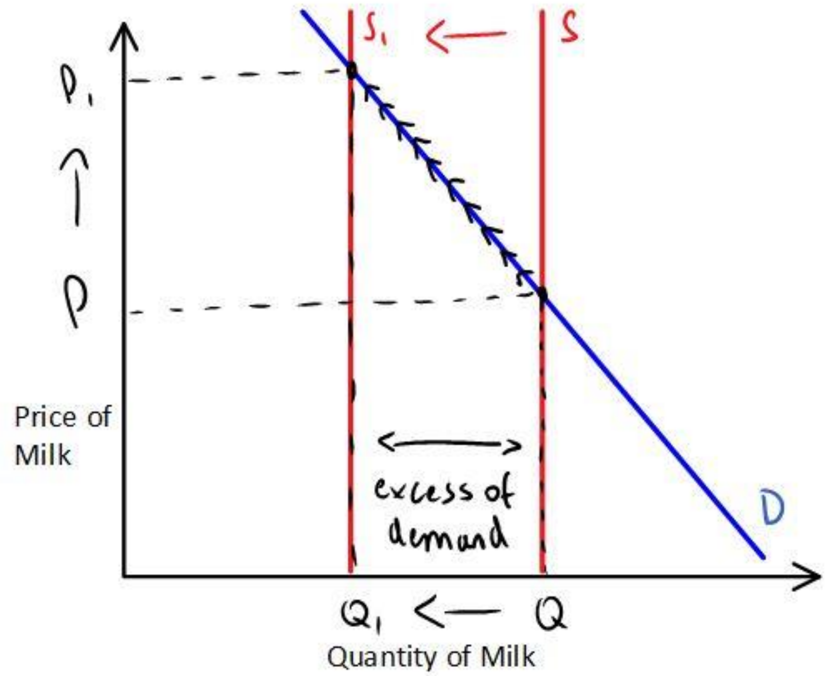

Diagram 2: Rise in price of FOP – Shift in supply