1 September 2011

Top terms

Terms of trade rose 2.3% in Q2

- **The terms of trade for the June quarter rose to its highest level since 1974. Higher world commodity prices continued to be a net benefit to New Zealand.**
- **We expect this to mark the peak in the terms of trade for the next couple of years. However, it should remain at historically high levels, providing a key pillar of the ongoing economic recovery.**

Overseas Trade Indexes (qtr % chge)

	2010Q2	2010Q3	2010Q4	2011Q1	2011Q2
Terms of Trade	2.0	3.0	0.8	0.8	2.3
Export Prices	3.7	-0.1	0.5	6.3	1.8
Import Prices	1.7	-3.0	-0.2	5.4	-0.5
Export Volumes (s.a.)	-0.6	-2.1	4.0	-0.2	0.5
Import Volumes (s.a.)	2.1	3.1	3.9	4.5	-2.4

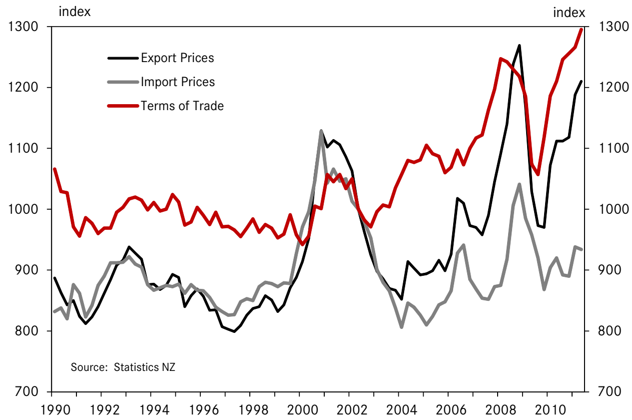
New Zealand's terms of trade improved by 2.3% in the June quarter, setting another multi-decade high for the third time in a row. Once again, it was a story of strength in world prices of commodities outpacing the gains in the exchange rate; as a net exporter of commodities, this has worked in New Zealand's favour in recent years.

Export prices rose 1.8% for the quarter, with the main contributors being a 13% rise in crude oil, a 12% rise in wool, and a 4.5% gain for dairy products. The latter reflects the prices that were contracted earlier in the year; the fall in dairy prices over the last few months will be captured by the terms of trade in the second half of 2011. Gains were modest for other commodities, and prices of non-food manufactures were on the sharp end of the NZ dollar's strength, falling by 0.8%.

Import prices were also influenced by global commodity price strength to some degree, with iron and steel up 7.8%, petroleum up 4.3%, and crude materials (such as fertiliser ingredients) up 5%. However, the strong NZD helped to keep down prices of manufactured goods, which make up the majority of our imports. Overall import prices fell by 0.5%.

Export volumes rose 0.5% for the quarter, with declines in dairy, oil, wood and wool, but a 5.6% increase in meat. There was also an impressive 8% lift in non-food manufactured goods, which finally reached above their previous peak from back in 2004. Stats NZ noted that pleasure boats made the biggest contribution to the increase; other notable items (iron, aluminium) were more in the commodity space than the 'manufacturing' title suggests.

Export and Import Prices



The 2.4% fall in import volumes largely reflected the fact that no large aircraft were brought in during Q2, compared to two in Q1. Notwithstanding the latest drop, imports have rebounded strongly since the end of the recession two years ago, with business investment (capital goods and transport equipment) leading the charge.

Market implications

A strong terms of trade affects the New Zealand economy in two key ways. First, it boosts exporters' incomes directly, which then flows through to spending in other sectors. Second, it contributes to the strength of the NZD exchange rate. This improves New Zealanders' purchasing power overseas, but also provides a headwind for non-commodity exporters and import-competing industries.

We think that today's figures will mark the peak in the terms of trade for the near future, and we expect a drop of about 6% over the next year. Export commodity prices are starting to head lower as the global economy cools, though we expect this to be partly buffered by an easing in the exchange rate over the next year too.

Today's result appears to be much in line with the Reserve Bank's projections, so has no implications for this month's Monetary Policy Statement – that conversation will be around whether the renewed turmoil in global markets outweighs the clear signs of activity and inflation pressures building in the domestic economy.

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