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Westpac Institutional Bank

Shooting for the stars

Terms of trade rise 0.6% in Q4

- **New Zealand's terms of trade hits a new 37-year high as global food prices rise faster than oil and manufactured goods.**
- **Agricultural export volumes rebound.**
- **But higher prices will take time to feed through to broader economic activity.**

Overseas Trade Indexes (qtr % chge)

	2009Q4	2010Q1	Q2	Q3	Q4
Terms of trade	5.8	6.1	2.0	3.0	0.6
Export prices	–0.3	10.5	3.7	–0.1	0.3
Import prices	–5.7	4.2	1.7	–3.0	–0.4
Export Volumes (s.a.)	–1.7	2.8	–0.3	–2.4	4.5
Import Volumes (s.a.)	1.5	3.0	1.1	3.8	3.8

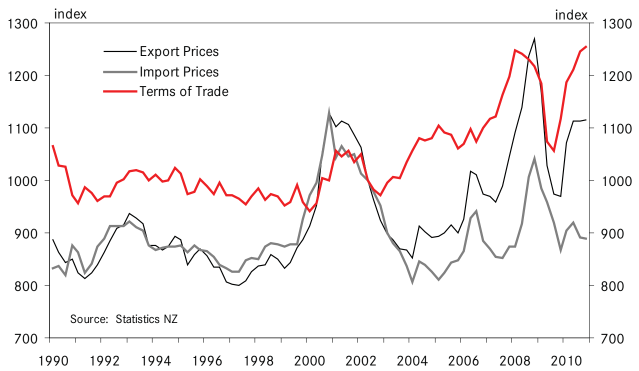
New Zealand's terms of trade rose by a further 0.6% in the fourth quarter of 2010, taking it to a new 37-year high. New Zealand has not faced such a favourable set of external conditions since the early 1970s.

Export prices were up 0.3% – only a touch weaker than the 0.6% increase we had pencilled in. The composition was also largely in line with what we had anticipated. Of note, there was an 8.8% decline in dairy prices in the quarter - the delayed impact of temporarily softer dairy prices in mid-2010 (contracts agreed then were only just being delivered later in the year). However this was swamped by higher prices for other commodity exports including meat (+5.1% led by a 10.7% rise in lamb prices), fruit (+14.2%) and wool (+23%).

Import prices were weaker almost across the board with the notable exceptions of the price of imported food and beverages (+4.2%) and oil petrol and petrol product imports (3.8%). A slightly stronger NZD in the quarter likely helped moderate the effects of rising global food and oil prices on the prices paid for these goods by New Zealand importers.

On the volumes side of the ledger, export volumes increased in line with expectations, while import volumes were somewhat weaker. Export volumes rose 4.5% including a 9% lift in dairy

Export and Import Prices



exports while import volumes were up a more modest 3.8%. Manufactured exports were notably weaker, down 3.6% in the quarter. Many manufactured exporters are doing it tough, battling a high NZD/USD exchange rate, without the benefit of increasing world prices for the goods they produce (unlike many commodity exporters).

The services terms of trade rose by 4.5%, mainly due to cheaper imports of services. There were notable price declines for sea freight and personal travel services (read international airfares).

Market implications

The data was broadly as expected, so there are no immediate market implications and there was little market reaction.

The general theme of rising global food prices boosting New Zealand's terms of trade is critically important for the overall economic outlook – this is now bigger than the "Dairy Boom" of 2007/08. The most obvious economic impact so far has been support for the exchange rate. The high NZD amounts to improved purchasing power for New Zealanders and, if sustained, represents an improvement in our living standard. But the stronger NZD also hurts NZ firms facing international competition, and has therefore acted as a drag on GDP growth. NZ firms that compete with imports exhibited notable weakness last year.

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The rising terms of trade is also directly boosting exporter incomes, but it will take time before this translates into faster GDP growth. This season, dairy farmers are set to earn $1.4bn more than they did last season – a cash injection equivalent to 0.7% of GDP. So far, many farmers have been focussed on debt reduction, which has limited the extent of “trickle down” from farm incomes to the wider economy. But there is only so long this “deleveraging” story can remain dominant. We do expect to see the agricultural sector gradually ramping up spending, investment and M&A activity through 2011, providing much-needed support for economic growth this year.

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