1 June 2011

Edging up

- **Terms of trade up 0.9% to the highest level since 1974.**
- **Further gains in export prices were partially offset by sharply higher import prices.**
- **A strong terms of trade is good news for the NZ economy and will support stronger economic growth going forward.**

Overseas Trade Indexes (qtr % chge)

	2010Q1	2010Q2	2010Q3	2010Q4	2011Q1
Terms of Trade	6.1%	2.0%	3.0%	0.8%	0.9%
Export Prices	10.5%	3.7%	0.0%	0.5%	6.3%
Import Prices	4.1%	1.8%	-3.0%	-0.2%	5.4%
Export Volumes (s.a.)	2.9%	-0.4%	-2.3%	4.0%	-0.3%
Import Volumes (s.a.)	3.0%	1.0%	3.7%	3.8%	5.1%

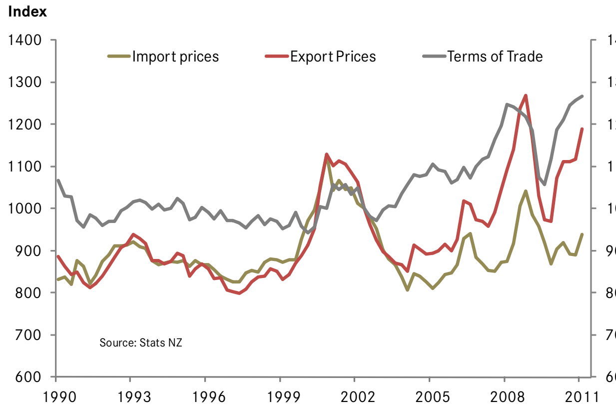
New Zealand's terms of trade rose 0.9% in the first quarter of 2011, leaving the index 6.8% higher than a year ago. This is the sixth consecutive quarterly increase and leaves New Zealand's external conditions in their best shape since the early 1970s.

The strong terms of trade impacts the NZ economy in two key ways. It boosts exporters' incomes directly – which then flow through to growth in other sectors. And secondly it has contributed to the high exchange rate. This improves New Zealanders' purchasing power but also provides a headwind for non-commodity exporters and importing competing industries.

Export prices rose a hefty 6.3% in the quarter (even stronger than the 5.2% rise we had pencilled in). As expected dairy prices reversed Q4's 8.8% fall climbing 5.5% - making a significant contribution to the total rise (the terms of trade data reflects contracted prices which tend to be agreed in advance and therefore tend to lag spot prices). In addition meat and wool prices continued to surge ahead in the first few months of the year on the back of strong demand and tight global supplies (lamb prices rose 9.8%, beef and veal, and wool prices were up 12%).

Import prices advanced 5.4% in the March quarter, broadly in line with our own forecast (+4.7%) but noticeably stronger

Export and Import Prices



than the market had expected. Import prices rose almost across the board (a 1.7% fall in iron and steel prices and a 0.4% fall in mechanical machinery prices the only exceptions). That said, sharply high oil prices were certainly a dominant feature on this side of the ledger. Strong demand combined with rising political tensions in the Middle East and North Africa saw global oil prices rise sharply at the start of the year and accordingly import prices of petrol and petroleum products rose 20.3%. And with little offset provided by the exchange rate in the March quarter, rising global oil and non-oil commodity prices pervaded other import prices. Non-fuel crude materials prices were up, as were plastics and chemical import prices. Meanwhile clothing and footwear prices were up a hefty 7.6% (with rising cotton prices a potential driver). Higher global food prices were also reflected on the imports side of the ledger.

Export volumes were down 0.3% in the quarter as further growth in dairy and forestry exports was offset by softer meat and non-food manufactured exports. Dairy export volumes are now sitting at record highs while low slaughter volumes have weighed on meat exports. Manufactured export volumes continued to fall this quarter, a 0.9% fall following a 3.7% fall the previous quarter – and serve as a reminder that not all exporters are benefitting from high export prices.

The services terms of trade fell 0.9%. A 1.7% increase in exports of services prices was more than offset by a 2.6%

increase in imports of services prices, with higher oil prices reflected in increased travel and transportation costs.

Market implications

Today's data were broadly in line with expectations and elicited no reaction from the markets. However the modest improvement in the terms of trade reminded us of two things. Strong global demand for food commodities is benefitting "NZ inc" as one of the world's biggest net food exporters. Secondly NZ is also a commodity importer. While the exchange rate provides some offset – NZ is not immune from the impact of rising global commodity import prices. Nonetheless high commodity export prices continue to dominate the terms of trade, pushing it to historic highs and providing a key pillar of support for improving economic activity.

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