3 Septemebr 2012

Westpac Institutional Bank

Falling for now
Q2 Terms of Trade

- **New Zealand's terms of trade fell 2.6% in the June quarter.**
- **This is the 4th consecutive fall in the terms of trade and leaves the index 6.8% below levels of a year ago.**
- **Falling export prices have dragged the terms of trade lower, but we suspect we are getting close to a turning point. We expect commodity prices to be improving by the end of this year and into next.**

Overseas Trade Indexes (qtr % chge)

	2011Q3	2011Q4	2012Q1	2012Q2
Terms of Trade	-0.6%	-1.4%	-2.3%	-2.6%
Export Prices	-4.0%	1.7%	-3.7%	-1.0%
Import Prices	-3.4%	3.2%	-1.5%	1.7%
Export Volumes (s.a.)	-0.3%	2.6%	-0.6%	-0.4%
Import Volumes (s.a.)	1.8%	-1.5%	5.6%	-3.1%

New Zealand's terms of trade (the ratio of export prices relative to import prices) continued its downward slide in the June quarter, slipping 2.6%. The terms of trade has now fallen 6.8% from the multi-decade highs reached in mid-2011.

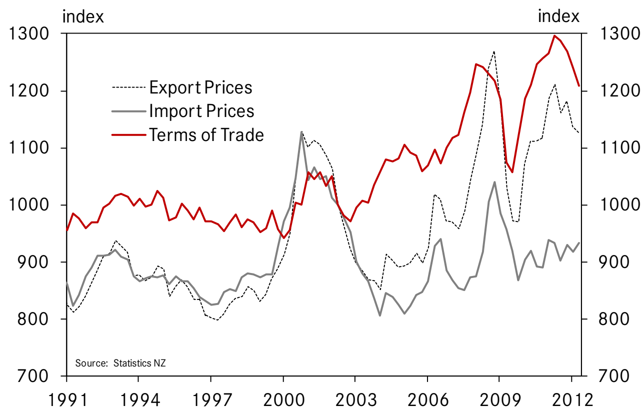
The fall over the last year has in large part been driven by lower export prices, which have reflected the more challenging global conditions facing New Zealand exporters. Global growth has slowed, and with it demand for New Zealand's key commodity exports.

Today's data showed widespread falls in export prices during the 3 months to June. This included lower prices for dairy (-2.6%), meat (-2.3%) and wool (-6%), and forestry products (-0.2%). Dairy prices have now fallen 13.6% over the last year while meat prices are down 7.3%.

Export volumes were a touch softer in the June quarter – falling 0.4%. Weak dairy exports weighed on export volumes – though we think this is largely a timing issue. The 2011/12 season was a record breaking one for Fonterra, and we've observed a big jump in dairy export volumes in June and July merchandise trade data.

Looking ahead, export prospects are set to improve. On our forecasts, the worst of the Chinese slowdown is now behind us.

Export and Import Prices



As the significant fiscal and monetary policy stimulus unleashed by Chinese authorities starts to gain traction toward the end of 2012, the scene should be set for a pickup in activity in 2013 which should in turn boost demand for NZ's commodity exports. At the same time, there are signs of tightening global supplies in meat and dairy markets. Adverse weather conditions in the US and elsewhere have sent grain prices skyrocketing over the last few months. With grains a crucial input to livestock production in the Northern Hemisphere, rising input costs are eventually expected to translate to reduced growth in supply, and upward pressure on global prices.

The 1.7% rise in import prices was led by an 8.4% jump in the prices for petroleum products. Excluding this category import prices were up a more modest 0.3% in the quarter on the back of a 1.7% fall in the TWI over the period. Similarly the 3.1% fall in import volumes in the quarter was exaggerated by a 12% fall in imports of intermediate goods (which reversed a 12% rise the previous quarter). The strong increase in capital imports volumes (up 12.7% s.a. excluding transport equipment) will translate to solid growth in investment in the coming months, while imports of consumer goods were up a robust 2.4% in the quarter.

Market Implications

Today's data did little to change our view of the New Zealand economy, and we suspect this will also be the case for the Reserve Bank. While the terms of trade has slipped noticeably

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over the last year, it remains relatively high – around 7% above the average level of the last 10 years. And recent developments in agricultural markets support our view that the current weakness will prove to be cyclical rather than structural. We expect New Zealand export prices to improve late this year and next year, and remain convinced that over a longer horizon, global demand for food (underpinned by urbanisation, income and population growth) will underpin a structurally higher terms of trade for New Zealand.

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