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Westpac Institutional Bank

Slow slide

Q4 Terms of Trade

- **New Zealand's terms of trade fell another 1.4% in the December quarter.**
- **This is the second consecutive quarterly fall in New Zealand's terms of trade as it starts to slide from the exceptionally high levels reached in mid-2011.**
- **External conditions have become more challenging for New Zealand exporters over the last 6 months and we expect this to continue to weigh on export prices further in the first half of 2012. However over a longer horizon we expect a rebound with food prices underpinned by important global trends such as urbanisation, income growth and population growth.**

Overseas Trade Indexes (qtr % chge)

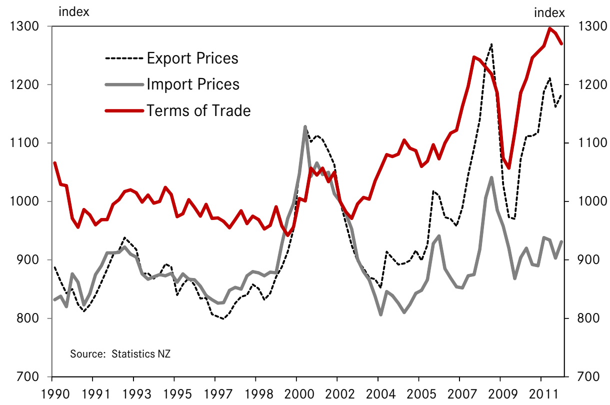
	2011Q1	2011Q2	2011Q3	2011Q4
Terms of Trade	0.8%	2.4%	-0.6%	-1.4%
Export Prices	6.3%	1.9%	-4.0%	1.7%
Import Prices	5.40%	-0.50%	-3.40%	3.20%
Export Volumes (s.a.)	-0.30%	0.20%	-0.40%	2.90%
Import Volumes (s.a.)	4.20%	-2.10%	2.40%	-2.10%

Implications

New Zealand's terms of trade continued to slide from exceptionally high levels in late 2011. The 1.4% fall in the index in the December quarter leaves the terms of trade 2% below its recent peak. While this still clearly leaves the index at elevated levels, it also hints that the purple patch of late 2010/early 2011 is fading. Global growth prospects have deteriorated and, as expected, this has started to weigh on international prices for NZ exports, more so than import prices.

However in the December quarter (a period where financial market volatility was high, and uncertainty prevailed as bad news on the European debt crisis dominated the headlines), the fall in international prices of our export products was more than offset by a fall in the exchange rate. On a TWI basis, the currency fell 3.1% during the quarter, boosting returns for NZ exporters when

Export and Import Prices



measured in New Zealand dollars, while at the same time making imports more expensive.

Details of the release showed that the 1.7% lift in export prices included a 1.1% fall in dairy prices and a 3.4% increase in meat prices. But volume growth was the other way around. Farmers almost across the board have enjoyed excellent pasture growth this season, and this has translated to a bumper year for dairy production but has had the opposite impact on meat exports, at least temporarily. With more grass, sheep and beef farmers have retained stock on farm for longer, opting to send stock to the works later (and heavier), temporarily dampening export volumes. Dairy export volumes were up 6.3% (s.a.) in the December quarter, while meat exports fell 6.9% (s.a.). Overall export volumes rose a healthy 2.9% in seasonally adjusted terms.

Import prices rose across the board as a weaker New Zealand dollar pushed up the cost of buying goods from off shore for New Zealanders. The 3.2% lift in import prices was led by higher prices for petroleum and petroleum products (3.9%), mechanical machinery (3.7%), transport equipment (3.2%), food and beverages (3.3%). That said, attractive prices for imported capital equipment have probably been one factor encouraging the strong investment growth we've seen over the last year.

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Prices of capital equipment are still more than 7% below a year ago and capital equipment import volumes are up almost 18% over the same period and are now above their pre-recession levels. In aggregate, import volumes contracted 2.1% in the December quarter in seasonally adjusted terms on the back of softer intermediate and consumption imports.

Market implications

Although today's data was perhaps a touch stronger than the RBNZ was expecting in the December MPS it is unlikely to contain too many surprises. Instead the commentary in next week's MPS is likely to be dominated by the weaker inflation outlook, signs of a pickup in domestic activity, and debate about the evolution of bank funding costs and their impact on retail rates lending and borrowing rates.

We remain convinced that New Zealand's terms of trade will slip further in the coming months as slower growth in Asia in particular weighs on commodity prices. Yet even at their trough the terms of trade will be at historically elevated levels. We continue to be firmly optimistic about prospects for New Zealand export prices over a longer horizon, with food prices to be underpinned by the important global trends of urbanisation, income growth and population growth.

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