

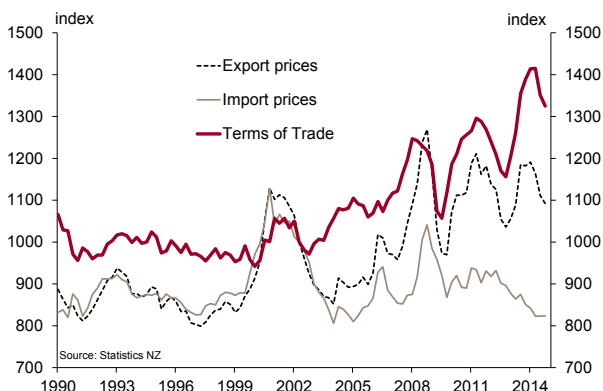
The end is nigh

NZ Terms of Trade, December quarter 2014

- The terms of trade fell by 1.9% in the December quarter, in line with our forecast.
- Dairy prices continued to fall sharply, but the impact was softened by higher prices for other commodity exports.
- Import prices rose slightly overall, despite a steep drop in fuel prices.
- With dairy prices now rebounding while oil prices remain soft, the current downturn in the terms of trade looks to have almost run its course.

	Mar-14	Jun-14	Sep-14	Dec-14
Terms of Trade	1.8%	0.1%	-4.5%	-1.9%
Export Prices	0.8%	-2.2%	-4.6%	-1.8%
Import Prices	-1.0%	-2.3%	0.0%	0.2%
Export Volumes (s.a.)	1.3%	-4.6%	1.6%	1.5%
Import Volumes (s.a.)	2.5%	3.4%	2.5%	1.6%

Export and Import Prices



New Zealand's terms of trade, the ratio of export to import prices, fell by 1.9% in the December quarter. The result was better than market expectations for a 3% fall, though it was close to our forecast of a 1.5% decline. The terms of trade is not typically a big event for financial markets, and the New Zealand dollar was left unchanged despite the positive news.

The December quarter was dominated by some large swings in commodity prices. On the exports side, dairy prices were down almost 15% for the quarter. Prices for dairy exports tend to be fixed around three months ahead of shipment, so the December quarter trade figures more or less reflect where dairy prices were around July to September last year, when they were experiencing their steepest decline. World dairy prices bottomed out around December and have risen sharply in the last couple of months, which will start to come through in the June quarter terms of trade.

The fall in dairy prices was offset to a large degree by higher prices for other commodity exports. Meat prices rose 12.4% as a supply shortage in the US drove a spike in beef prices; much of this is likely to unwind in the March quarter. There were also strong price gains for forestry products (up 8.4%), aluminium (up 8.4%) and wool (up 5.7%). Manufactured export prices also rose a healthy 3.5%, though this will have been more a product of the weaker New Zealand dollar over that time.

On the imports side, the sharp drop in world oil prices led to a 10% price decline for petroleum products over the December quarter. This will be followed by an even steeper decline over the March quarter – more than 20% based on the current run rate. Petroleum makes up around one-sixth of New Zealand's import bill, so price shifts of this magnitude will have a powerful impact on the terms of trade. Indeed, just a few months ago we were expecting the terms of trade to decline by 11% from its peak in this cycle; now, the 6.4% fall in the terms of trade to date looks to be close to the end of the matter.

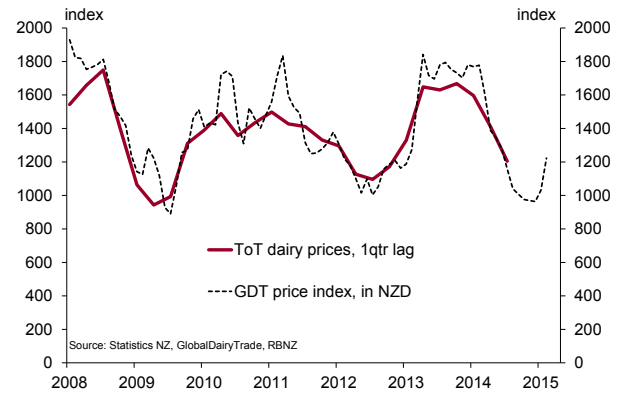
Cheaper oil, however, was fully offset by higher prices for other imports. Even manufactured imports, which have had a long-running downward trend in prices, rose by 2% over the quarter. Again, much of this will have been due to the lower NZ dollar. But it does provide another hint that pipeline price pressures are not as benign as they might seem, outside of fuel.

We expect another small decline in the overall terms of trade in the March quarter, with cheaper oil again helping to offset the last phase of the fall in dairy export prices. If this proves to be the bottom of the current cycle, it will mean that the terms of trade has 'troughed' at a higher level than the previous peak seen in 2011.

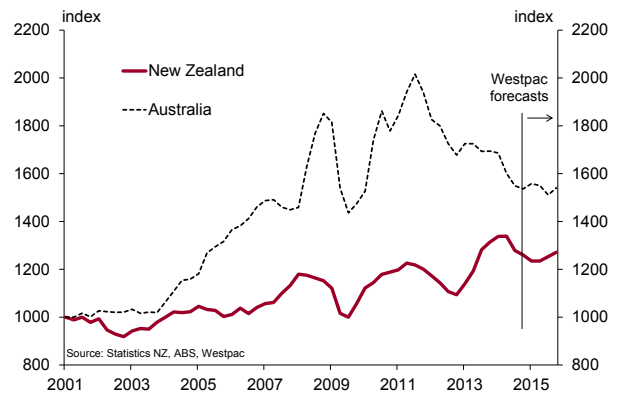
That stands in stark contrast with Australia's recent experience – while Australia received a much larger boost to its terms of trade over the last decade as a whole, the decline from its peak has been running for over three years, and we expect it to bottom out at levels similar to those seen during the Global Financial Crisis. The relative experience of the two nations' terms of trade is consistent with the strength of the NZD/AUD exchange rate in recent years.

Michael Gordon
Senior Economist

Dairy export prices



Relative terms of trade



Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Felix Delbrück, Senior Economist
+64 9 336 5668

Satish Ranchhod, Senior Economist
+64 9 336 5669

Any questions email:
economics@westpac.co.nz

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