Westpac

Institutional Bank

1 September 2014

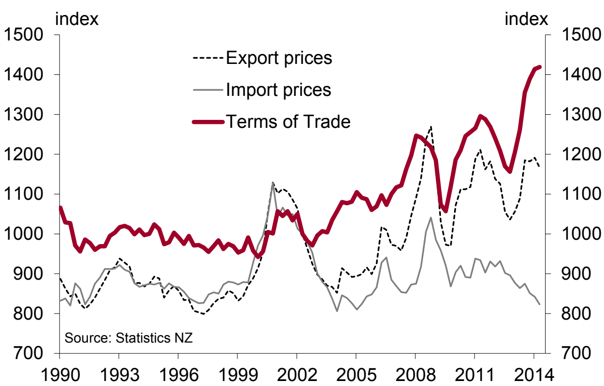
One last hurrah

Q2 NZ Terms of Trade

- The terms of trade rose by 0.3% in the June quarter, against expectations for a decline.
- Dairy and forestry export prices fell as expected, in response to what should prove to be a temporary build-up in global inventories.
- Import prices fell by slightly more than export prices, largely due to a larger than expected drop in petroleum prices.
- The terms of trade responds with a lag to changes in world commodity prices. We expect it to fall by around 10% by year-end.
- However, the long-term picture for New Zealand's exports remains intact, and by the end of the year we expect commodity prices to be staging a recovery.

	Sep-13	Dec-13	Mar-14	Jun-14
Terms of Trade	7.5%	2.5%	1.8%	0.3%
Export Prices	8.9%	-0.3%	0.8%	-2.0%
Import Prices	1.3%	-2.7%	-1.0%	-2.3%
Export Volumes (s.a.)	-1.6%	9.1%	0.9%	-5.3%
Import Volumes (s.a.)	5.1%	0.1%	2.7%	3.6%

Export and Import Prices



New Zealand's terms of trade surprised by eking out another small increase in the June 2014 quarter, maintaining its position at a four-decade high. We were forecasting a 2.3% fall (and the median market forecast was for a 3.5% drop), given the well-publicised declines in dairy and wood export prices in recent months. While those came through largely as forecast, they were offset by a greater than expected fall in import prices.

Today's results don't alter the broader picture for the terms of trade. Much of the surprise on imports came from a 3.9% fall in petroleum prices, an item that tends to be quite volatile from one quarter to the next. And on the exports side, we know that the biggest hit to prices is yet to come – most of the recent decline in world dairy prices will be captured in the next two quarters' trade figures.

We continue to expect the terms of trade to fall by around 10% from its peak over the next year. Falling export revenues will undoubtedly weigh on both confidence and spending in the agriculture sector and beyond. Financial markets are starting to sit up and take note of this impact, with the fall in the New Zealand dollar in recent weeks providing a modest shock absorber for the economy.

However, we'd emphasise that we see the recent weakness in dairy export prices as a temporary phenomenon, the result of a surge in global milk production colliding with a softening in Chinese demand. We expect dairy prices to stabilise and start recovering by the end of this year – though this will be necessary just to meet our forecast of a $5.80/kg milk price from Fonterra for this season.

Turning to the details, export prices fell 2% over the June quarter, less than our estimate of a 3.3% drop. As expected, dairy products (down 4.3%) and forestry products (down 6.5%) were the most notable points of weakness. Prices fell to a lesser extent over most of the major groups, although meat prices were up slightly (and have continued to hold up since then).

The fall in dairy export prices over the June quarter seems mild, given that world prices in the fortnightly GlobalDairyTrade auctions have fallen by about 40% since February. However, the average time lag from pricing to shipment of dairy exports is around three months, which means that the fall in prices didn't show up in the trade figures until late in the June quarter. The bulk of the fall in dairy prices will be captured in the September and December quarter instalments of the terms of trade.

Import prices fell by 2.3% over the quarter, compared to our estimate of a 1% fall. Most of the surprise was on petroleum imports, with prices down 3.9% (and volumes up a whopping 13.4%). Petroleum prices tend to be quite volatile from quarter to quarter, and the positive surprise in this case is unlikely to be repeated. Elsewhere, import prices were down across the board, with non-food manufactures down 2%, which is consistent with the stronger New Zealand dollar over the quarter.

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