2 December 2013

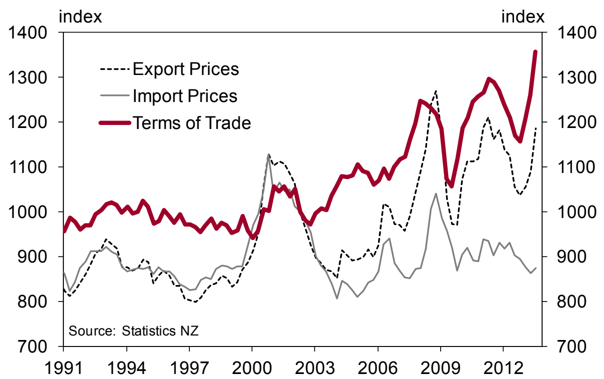
Westpac Institutional Bank

Bursting higher
Q3 NZ Terms of Trade

- New Zealand's terms of trade jumped 7.5% in the September quarter, hitting a new 40 year high.
- Export prices have gone from strength to strength. Although dairy remains the standout performer, prices for a broad range of other commodity exports have also firmed.
- The volume of exports in the September quarter was impacted by last summer's drought. But it is only a matter of time before the rapid rebound in agricultural production since then is reflected in trade data.
- The terms of trade could edge a little higher from here, but won't remain this high indefinitely. We expect commodity prices to soften next year as supply increases.

	2012Q4	2013Q1	2013Q2	2013Q3
Terms of Trade	-1.2%	4.2%	4.6%	7.5%
Export Prices	-1.8%	1.9%	3.1%	8.9%
Import Prices	-0.7%	-2.1%	-1.5%	1.2%
Export Volumes (s.a.)	-0.4%	0.0%	-6.4%	-2.1%
Import Volumes (s.a.)	-1.3%	3.0%	4.3%	5.6%

Export and Import Prices



The terms of trade rocketed to a 40 year high in the September quarter, driven by sharply higher export prices. For now, the rest of the world continues to be willing (and able) to pay top dollar for New Zealand's key commodity exports. Add subdued global inflation to the mix and it spells good news for New Zealanders' purchasing power abroad.

The rural sector in particular is reaping the benefits of the high terms of trade in the form of strong farm gate prices. Combined with a strong lift in production, this is giving rural incomes a big boost. In the dairy sector alone, our forecast of a $8.30 payout for the current season, plus 8.5% lift in production, implies a revenue boost of around $5bn on last season – that's around 2.5% of GDP. This is clearly good news for rural economies and is helping ensure that the current upswing in domestic economy is broadening far beyond the bright lights of Auckland or the construction hotbed in Canterbury.

The high terms of trade is also one factor which helps explain why the NZ dollar has been so strong. Although the RBNZ will likely remain concerned about the potential for a persistently overvalued high exchange rate to damage the economy, at face value a higher terms of trade makes the strong New Zealand dollar a little more palatable. At the margin this may mean the RBNZ is more comfortable about beginning a hiking cycle. More broadly, the key messages in this relatively dated data are unlikely to surprise the Bank. Prices for New Zealand's key commodity exports are high, and while export volumes were hit by the drought, these are set to recover over the coming quarters.

Details

The dairy sector once again garnered much of the limelight in today's data. Prices rose a whopping 23.9% in the September quarter and are 46% higher than a year ago. More timely information provided by fortnightly GlobalDairyTrade auctions shows that since September, demand has remained robust. Prices have softened – but only a little. This is a particularly impressive performance given the rapid rebound in domestic milk production we've seen since last summer's drought.

Although the dairy sector's star billing in the terms of trade data is clearly justified (dairy accounted for more than a quarter of all goods exported in the year to September), other commodities including logs, meat and wool prices have all played strong supporting roles. In many of these markets tight supply has contributed to firm prices, but it appears that so too has New Zealand's strong relationship with China. New Zealand exporters may be feeling the benefits of the Free Trade Agreement with China, even as the pace of growth in the Chinese economy slows.

Export volumes fell further in the September quarter and have now fallen over 8% over the last 2 quarters as a consequence of last summer's drought. However, excellent spring growing conditions this year should ensure this is only a temporary phenomenon. Dairy production in particular has rebounded strongly. Lamb and beef exports are likely to take longer to recover after breeding stock was culled during the drought – but weights in this sector should benefit from plentiful feed in most parts of the country during spring.

Add to this the strong incentives high prices provide to producers in other parts of the world to up their production, and we don't think NZ export prices can stay at such elevated levels indefinitely. We expect dairy prices in particular to come under downward pressure next year as global supply ramps up.

On the imports side of the ledger, movements were less extreme. Import prices rose 1.2% with the movement spread across a broad range of sectors. Import volumes continued to march higher, led by capital imports. This partly reflects a few large one-off's (e.g. the purchase of helicopters by the defence force) but stronger imports of capital goods also indicates that soaring business confidence is increasingly translating into more investment by firms.

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