

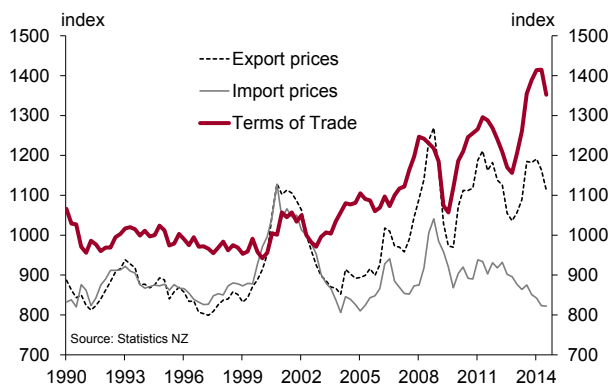
We are beginning our descent

NZ Terms of Trade, September quarter 2014

- The terms of trade fell by 4.4% in the September quarter, in line with market expectations.
- Prices fell sharply for dairy products, New Zealand's biggest export item. Other export prices were mixed.
- The decline in import prices was halted over the September quarter as the New Zealand dollar softened slightly.
- Weakness in world prices for dairy exports will continue to flow through to the official data for a few more quarters.

	Dec-13	Mar-14	Jun-14	Sep-14
Terms of Trade	2.5%	1.8%	0.1%	-4.4%
Export Prices	-0.3%	0.8%	-2.3%	-4.5%
Import Prices	-2.7%	-1.1%	-2.3%	-0.1%
Export Volumes (s.a.)	10.0%	0.6%	-4.8%	-0.1%
Import Volumes (s.a.)	0.5%	2.9%	3.5%	2.7%

Export and Import Prices



New Zealand's terms of trade fell by 4.4% in the September quarter, leaving it down slightly on the same time last year. The fall came as no surprise to us or the rest of the market, as it was largely the product of the sharp downturn in world dairy prices that has garnered a lot of market attention this year.

The fall in world dairy prices that we've seen to date is likely to weigh on the terms of trade through to the June quarter next year. By that date, we expect the terms of trade to be 11% below its recent peak. However, that decline could be larger if dairy prices fail to stabilise and recover as we expect next year, or smaller if the recent fall in imported oil prices is sustained.

The fall in the September quarter terms of trade was driven entirely by the exports side. Dairy product prices fell by 11.4%, the biggest quarterly drop since a 13% fall in the September 2012 quarter. Other export prices were mixed, with gains in meat (+4.3%) and wool (+3.3%) and falls in wood products (-3.9%) and manufactured goods (-0.7%).

Dairy prices in the twice-monthly GlobalDairyTrade auctions have halved from the peaks reached in February this year, more than reversing the steep run-up in prices last year that was driven by concerns about drought. The story this year has been almost the reverse: a strong lift in global milk supply, partly in response to last year's high prices, at a time that growth in Chinese demand has slowed.

Dairy export prices are typically set several months in advance of shipment, which means that the terms of trade lags auction prices by around three months. That means we already have a fairly good idea of where the terms of trade will be heading over the next couple of quarters: even if auction prices stabilise and start to gradually recover early next year, as we expect, the official export price index may not bottom out until the June quarter next year.

The mixed performance of New Zealand's export commodity prices as a whole serves as a reminder that not everything can simply be pinned on weak global demand. Product markets are

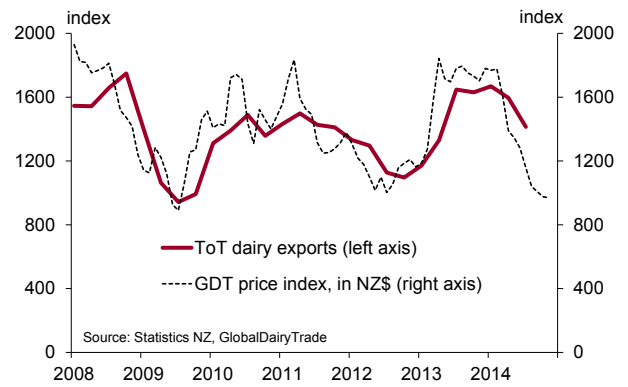
highly segmented, and supply conditions are often the more significant driver of prices in the short term. For instance, even as dairy prices tanked, beef export prices rose to a 12-year high, driven by supply shortages in the US. Lamb prices have also been gradually rising over the last year, despite the fact that economic growth in our key markets (Europe, the UK and more recently China) hasn't been all that remarkable.

Import prices were little changed in the September quarter, after a 6% fall over the previous three quarters. The New Zealand dollar's upward trend, which has more or less continuously acted to push down import prices over the last couple of years, came to a halt (down 0.4% on average over the quarter). We don't see this as the start of a sustained decline in the exchange rate, but even a break in its uptrend would mean that it no longer acts to suppress overall inflation.

The Terms of Trade report also revealed that export volumes were more or less flat in the September quarter, while the 2.7% rise in import volumes was largely due to the import of several large planes as Air New Zealand upgrades its fleet. Since the latter directly adds to business investment, it will have no net impact on September quarter GDP.

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Dairy export prices



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