

# The good oil

## Terms of trade -0.9% in Q4

- The terms of trade eased in Q4, but remain close to multi-decade highs.
- A 12% fall in the exchange rate led to significant price increases for many items, but a sharp fall in oil prices left the overall price indices with fairly muted gains.
- The impact of weaker world dairy prices has been delayed through longer-term price contracting, but we expect it to weigh on the terms of trade this year.

### Overseas Trade Indexes (qtr % chge)

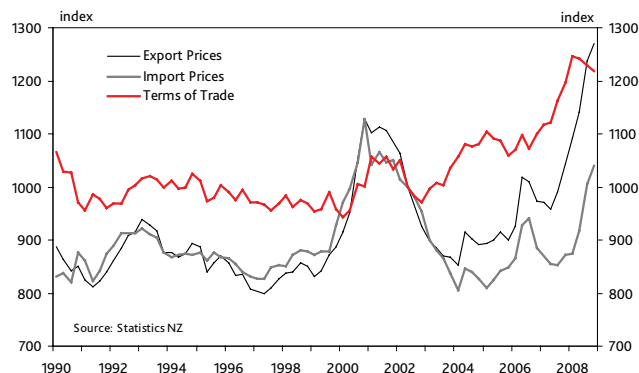
	2007Q4	2008Q1	Q2	Q3	Q4
Terms of trade	2.9	4.1	-0.4	-0.9	-0.9
Export prices	5.5	4.5	4.5	8.6	2.5
Import prices	2.5	0.3	4.9	9.6	3.4
Export Volumes (s.a.)	9.4	-3.6	-3.8	-2.3	-1.8
Import Volumes (s.a.)	4.9	-1.0	5.3	-5.3	-4.8

New Zealand's terms of trade (the ratio of export to import prices) remained at or close to 34-year highs throughout 2008, as the impact of the earlier boom in world commodity prices lingered on. The terms of trade dipped 0.9% in the December quarter, which (after allowing for an upward revision to the previous quarter) was in line with our forecast, although stronger than the market expected.

Despite a 12% fall in the trade-weighted NZ dollar, the overall price indices appeared fairly muted, with exports up 2.5% and imports up 3.4%. However, this masked some significant price movements for particular items on both sides of the ledger.

While dairy prices on world markets have plunged in the last year or so, Fonterra's use of longer-term contracts has allowed them to avoid the worst of the decline so far. This, combined with the sharp fall in the currency, saw the prices received for New Zealand's dairy exports rise by 4.8% to a new record high. This may seem at odds with Fonterra's forecast of a greatly reduced payout of \$5.10/kg for the current reason. But the trick is that the trade data captures the actual transaction prices – it doesn't account for the impact of currency hedging, which works against exporters when the exchange rate falls.

Export and Import Prices



The fall in the dollar was more than enough to offset weaker world prices for most other commodities as well. Meat prices rose 4.9% in New Zealand dollar terms, wool rose 9.9%, fish rose 10.8% and forestry rose 11.2%. By far the biggest drag on export prices was a 31.6% fall in crude oil, reflecting the sharp reversal in world prices since mid-2008.

Oil was also the major factor on the import side of the equation – prices for petroleum products, by far our largest import item, fell by 22.4%, and prices for the previous quarter were revised lower as well. Elsewhere, manufactured imports captured the full effect of the weaker currency, with some hefty price increases in iron and steel items (+20.5%), mechanical machinery (+18.3%) which includes computers, and electrical machinery (+8.0%) which includes TVs.

With the price movements stripped out, net exports appear to have made a positive contribution to GDP in Q4, due to import volumes falling by more than exports. Export volumes were softer than we expected, though most of the shortfall came from a 17.5% fall in oil exports, reflecting the natural rate of decline in output from the Tui field and a planned one-week maintenance shutdown during the quarter. Tui began shipping to a domestic refinery for the first time in January, which will further detract from exports this year – though it should reduce the need to import crude oil by a similar amount.

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Dairy export volumes rose by 4% in seasonally adjusted terms, reflecting the increase in output from recent dairy conversions and a rebound from last year's drought. However, meat was down 1.7%, as a drought-induced slaughter last season led to lower stock numbers this year.

Import volumes fell a hefty 4.8% as expected, led by a 27.1% drop in passenger car imports. Difficulty in accessing credit, consumer caution about buying big-ticket items, and high fuel prices have hammered car sales in the last year, and the slide appears to have continued in the early part of this year.

### Market implications

There was no reaction to the data in either the currency or interest rates. Given the pace of developments in the global economy, figures from Q4 last year will generally be seen as too dated to warrant much market attention, aside from the GDP data to be published later this month. We are currently forecasting a 0.9% decline.

The terms of trade was stronger than the RBNZ's forecast of a 3.9% decline (though that was from the December *Monetary Policy Statement* and is clearly dated now). The RBNZ have been forecasting a drop in the terms of trade for the last year to no avail – one of the few areas where they have been overly pessimistic. Nevertheless, this is just one bright spot in a sea of gloom about the state of the world economy. We doubt this data will have any bearing on tomorrow's cash rate decision, where we expect a 100 basis point cut to 2.50%.

We expect the terms of trade to head lower in 2009, as contract prices for dairy exports fall more into line with the slump in spot prices. However, we're still optimistic about the long-term out for export prices, with the emergence of China and other developing economies leading to a sustained shift in world demand for food.

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