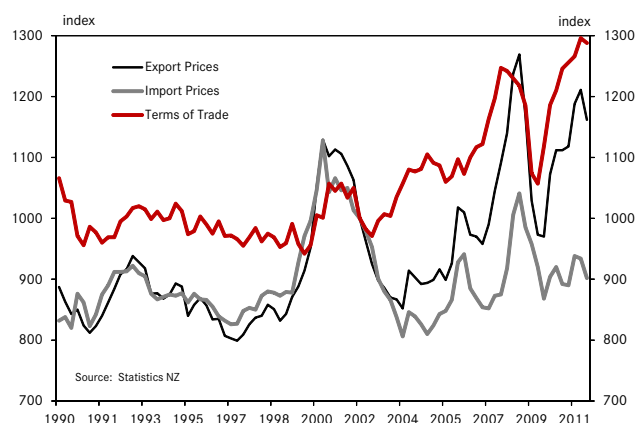


Changing direction

Q3 Terms of Trade

- The terms of trade slipped 0.7% in the June quarter, but remains near multi-decade highs.
- We expect further deterioration in the terms of trade over the coming quarters as slowing global growth weighs on demand for commodities. Yet even then, the terms of trade is expected to remain at high levels by historical standards, supporting exporters' incomes .
- A deteriorating external environment will underpin a reorientation of NZ's economic growth drivers over the next year, away from export sectors and toward the construction sector as reconstruction activity in Canterbury gathers pace.

Export and Import Prices



Overseas Trade Indexes (qtr % chge)

	2010Q4	2011Q1	2011Q2	2011Q3
Terms of Trade	0.8	0.8	2.4	-0.7
Export Prices	0.5	6.3	1.9	-4
Import Prices	-0.2	5.4	-0.5	-3.4
Export Volumes (s.a.)	3.8	-0.2	0.4	-0.7
Import Volumes (s.a.)	3.8	4.5	-2.4	2.7

As expected, New Zealand's terms of trade edged lower in the September quarter, slipping 0.7% after a run of 7 consecutive quarterly increases. While the index remains at very high levels, we think today's fall marks the start of a period during which the terms of trade will head lower (our forecasts incorporate a fall of just over 6% over the next year). We expect deteriorating global growth prospects will weigh on demand for commodities, putting downward pressure on export prices which will be only partially offset by a lower NZD. Nonetheless, given the starting point of such an exceptionally high level in the terms of trade, falls of this magnitude will leave the index at well above average levels of the past decade.

New Zealand has benefited from the strong terms of trade in recent years, via both the direct boost to exporters' incomes, and improved purchasing power for New Zealanders thanks to the stronger New Zealand dollar. But with the external outlook now

becoming tougher, fortunes for exporters are likely to moderate from here, putting downward pressure on the NZD (which in turn should provide at least a partial buffer for exporters' incomes).

Export prices fell 4% in the September quarter, led by falling dairy (-4.8%), meat (-4.8%) and forestry (-9.1%) prices. The former is a result of the significant falls in spot dairy prices we had already observed in the June quarter being reflected in contracted prices (which tend to reflect spot prices with a lag) in the three months to September. Weaker forestry prices are in part the result of sharply lower prices for log exports to China. Demand there slowed as inventory levels rose to well above average levels.

In seasonally adjusted terms, export volumes posted a modest decline in the quarter, down 0.7%. Meat export volumes were down 3.5% including an 11% fall in lamb exports. Plentiful pasture growth in most areas allowed farmers to retain lambs on farm for longer (despite the relatively high prices on offer) and while this has probably dampened export volumes in Q3 (and perhaps Q4), it should be at least partially reversed later in the season as both slaughter numbers and weights increase.

On the imports side of the ledger prices were down 3.4%. The biggest contributors to the fall were in the prices for mechanical machinery (-6.5%), food and beverages (-5.4%) and electrical machinery prices (-4.7%). Attractive prices for imported capital,

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(in part helped by the strong NZD) have probably encouraged firms to import capital equipment.

The 2.7% increase in import volumes in the September quarter (s.a.) was boosted by a 15% increase in capital equipment imports (ex-transport equipment). Capital goods imports are now just 6% below their 2008 highs. We think this signals a further pickup in plant and machinery investment over the second half of 2011. Meanwhile, imports of consumption goods have now surpassed their 2008 levels following a 5% lift in the September quarter.

The services terms of trade rose 3.1% in the September quarter, with the 0.1% fall in export prices outweighed by the 3% fall in service import prices. Lower oil prices during the quarter were probably reflected in lower prices for transportation and travel.

Market Implications

The global economic outlook will be one factor given significant thought by the RBNZ ahead of next week's Monetary Policy Statement. While today's data is probably broadly in line with their expectations, we will be looking closely for any indications the Bank has moved closer to our sub-consensus global growth outlook and implications this may have on their assessment of the outlook for the external sector.

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