Economic Note

Q2 Terms of Trade

2 September 2019

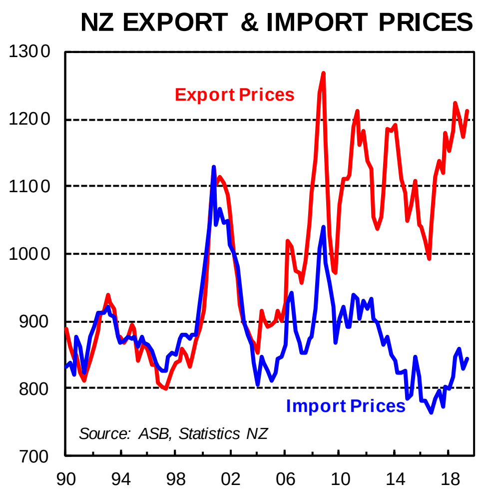
Flying high for now

- Q2 Terms of Trade post modest rise, and lie one third above historical averages.
- New Zealand's specialisation on food exports leaves us reasonably well placed, although slowing global growth will likely crimp export sector returns more generally.
- The NZD is playing its role as a shock absorber, with recent falls helping to cushion the export sector. If the domestic demand outlook weakens, the OCR will need to move lower.

Key Stats (qoq)	Actual	ASB	Market
Terms of Trade	1.6%	1.0%	1.0%
Export prices	3.4%	-	-
Import prices	1.8%	-	-
Export volumes (sa)	-2.6%		
Import volumes (sa)	-3.5%		

Summary

The NZ Terms of Trade (ToT) rebounded modestly in Q2, slightly above market expectations. The goods terms of trade set fractionally below their late 2017 peak and remain a key support to the NZ economic outlook. The volume splits showed a sharper fall for imports than exports, consistent with weakening domestic demand.



Looking over 2019 and into 2020, we expect the ToT to continue to firm gradually as dairy prices lift towards cyclical highs. New Zealand's specialisation on food exports leaves us reasonably well placed, although slowing in global growth will likely crimp export sector returns more generally.

The NZD is playing its role as a shock absorber, with recent falls helping to cushion the export sector. Importers and domestic consumers are unlikely to be as fortunate. **We expect the RBNZ to cut the OCR by a further 25bps in November (to 0.75%) to support domestic spending, with risk of more supportive policy action in 2020.**

Details

The goods ToT rose 1.6% over the June quarter (-0.8% yoy), slightly firmer than market expectations and our pick of a 1% quarterly increase. The goods ToT sit at a historically high level, less than 2½% below their late 2017 peaks and 34% above historical averages.

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Helped by the lower NZD (the TWI fell 1.8% in Q2), both export (3.4% qoq) and import prices (1.8% qoq) rose over the quarter. Higher food export prices were the standout. Dairy (10.6% qoq) and meat prices (4.9% qoq) rebounded from Q1 falls and lamb export prices hit their highest level since 1982. Wider food and beverage prices also rebounded from earlier weakness in Q2 (up 5.9% qoq). There were softer signs for other parts of the export basket, with falls for prices of wool (down 1% qoq), forestry products (down 1.7% qoq) and aluminium (-3.5% qoq).

Overall good **import prices rose 1.8% qoq (3.3% yoy),** supported by a 13.1% qoq rebound in petroleum and petroleum product prices. The **broader import price backdrop showed moderate quarterly increases** for capital (2.3% qoq), intermediate (+3.5% qoq) and consumer goods (+1.8% qoq) categories. **Higher input prices are likely to crimp business margins, as we expect only limited flow-through into broader consumer prices.**

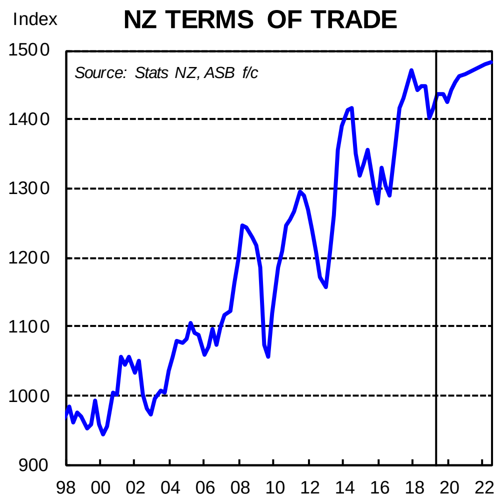
Q2 figures are historical. Dairy auction prices have eased about 7% since early May but we expect prices to firm towards the end of the year given the challenges faced by global production to keep pace with (still-resilient) global demand. As such, we have retained our 2019/20 Fonterra milk price forecast at $7.00/kg of milk solids.

The pace of NZ growth looks to have slowed, with the trade volume splits from the Q2 data confirming a pullback in the demand for imports. Import volumes slumped 3.5% qoq, weighed down by weaker consumption (-2.4% qoq) and intermediate imports (-4% qoq). The 19% qoq rebound in transport equipment, boosted capital goods imports (up 9.9% qoq), with ex-transport capital import volumes falling.

Export volumes declined 2.6% qoq as dairy exports (-9.3% qoq) receded from Q1 peaks and the dry and hot summer likely weighed on meat exports (-3.1% qoq). Weather over the coming months will be key for agricultural production and agricultural exports. It was a mixed bag for the remainder of the export basket.

The larger decline import volumes tentatively suggests that **goods trade contribution to expenditure-based GDP will be positive, but the sluggishness of domestic demand evident in the trade figures leaves us with little cause for cheer.**

Looking over 2019 and into 2020, we expect the ToT to continue to firm gradually as dairy prices lift towards cyclical highs. Fallout from the US-China trade war escalation has been relatively modest in global dairy markets so far. New Zealand's specialisation on food exports leaves us reasonably well placed despite the slowing in global growth. **We are not so upbeat on the broader export sector outlook as escalating trade tensions look set to further slow global economic growth, which will weigh on the demand for NZ exports more generally.**



The NZD is currently hovering close to 4-year lows against the USD and on a trade-weighted basis. However, if **more downside risks were to crystallise, we expect the NZD would continue to act as a shock absorber and fall further.** A still-lower NZD would support economic rebalancing of the NZ economy towards export-led growth**. If the domestic demand outlook weakens, however, the OCR will need to move lower.** We expect a 25bp cut in November, with the risk that the OCR heads lower still in 2020.

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