Economy Watch

1 June 2017

High Terms of Trade Data Not Without Hooks

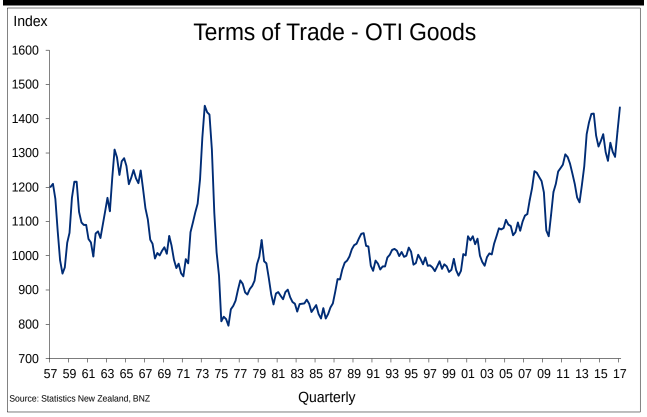
- Terms of trade highest since 1973
- A big support to nominal incomes
- So don't fret too much if Q1 GDP looks soft
- As seems the risk given the quarter's trade volumes

There is a strong positive income pulse brewing in the NZ economy, courtesy of rising export prices and relatively subdued import prices. But this, being price driven, will not show up directly in quarterly real GDP figures that might well look a bit softer in the near term. We expect the terms of trade to remain elevated compared to history, while we judge the near-term volume weakness to be transitory.

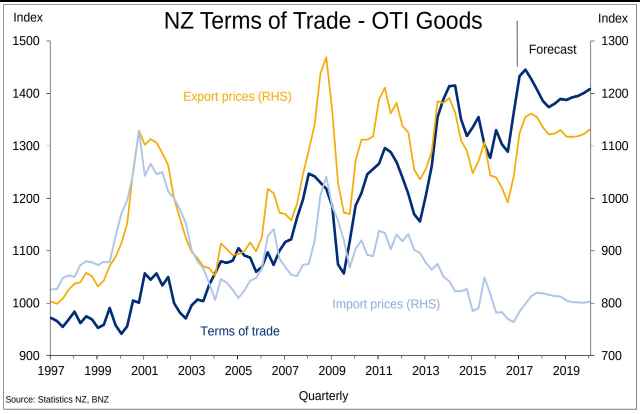
Let's start with the positive. We have been talking about the prospect of higher terms of trade for quite some time, but it is now starting to show up in the official statistics. The merchandise terms of trade rose 5.1% in the first quarter, to be up 7.8% on a year ago, and to its highest level since 1973. The quarterly result reflects export prices (+8% q/q) rising faster than import prices (+2.7%). Increases in both export and import prices fits with the general inflation lift that we have seen in 2017. Services terms of trade rose 0.1% q/q, to be up 2.6% on a year ago.

On the goods side, the export price gain reflects a firm and broad export price upswing for a range of primary products. This was well telegraphed by higher commodity prices. There might yet be a bit more to come through the official statistics in this regard such that the terms of trade could test its early-1950s all-time high. Some surprise today, to us at least, came via a 6.1% quarterly rise in non-food manufactured export prices.

High



Supportive Outlook



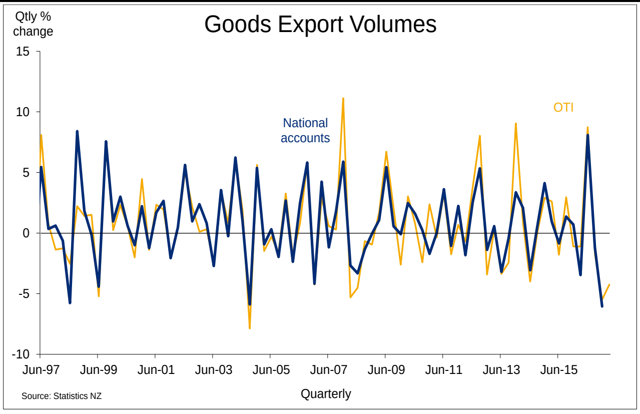
Even though we expect some pullback in the terms of trade over the coming year as primary product prices ease back, it is expected to remain at an elevated level relative to history. A higher terms of trade is a lift in purchasing power of the nation's exports; an income boost.

It is always difficult to know exactly how these terms of trade data line up against RBNZ expectations because the Bank prefers to analyse the terms of trade for goods and services on a national accounts basis (that data is due out with GDP on 15 June). But, prima facie, today's outcome suggests the terms of trade are tracking a touch stronger than the RBNZ anticipated in its May Monetary Policy Statement. If so, this would help offset the fact that the NZD is pushing above what the Bank projected. It might also add comfort to the Bank if its 0.9% pick for Q1 GDP proves too high, as increasingly looks like being the case.

Speaking of the currency, the NZD's strength is fundamentally supported by a high terms of trade. That is it shouldn't be a surprise to see a firm currency when prices for the products a country sells to the world are high relative to prices of the products a country buys from overseas. A firmer currency essentially distributes terms of trade gains around the economy.

It is important to note that this price-driven income effect from the terms of trade is not directly captured in real GDP, even though it can be just as powerful for lifting living standards (higher terms of trade directly lifts real gross national disposable income – a broader measure of real income growth than real GDP).

Still Low



That is worth bearing in mind when interpreting upcoming real GDP data, which could yet look a bit slow. We say this as we look at the direct GDP indicators in today's figures, like the 4.2% quarterly decline in export volumes and 1.2% rise in import volumes. At least some of this looks temporary. A big drop in dairy volumes in the quarter was no surprise and should bounce back in time, with signs milk production finished the season strong. The second consecutive quarterly drop in forestry product export volumes is in contrast to generally very positive indicators across that sector. The decline in non-food manufactured export volumes did surprise us, although is the flipside of the strange looking strong price lift noted above.

These suggest net goods trade will be a substantial drag on Q1 real GDP growth, counter to our prior expectations of real trade being at least neutral. This puts our current Q1 GDP estimate on notice for possible downward revision. But we haven't seen enough on the production side to change our 0.7% view just yet. We will finalise our view following next week's indicators for wholesale trade, building work and manufacturing. But it is worth noting that our expenditure based measure of GDP growth is now looking quite slim for the first quarter.

Today's trade indexes essentially split the already known trade values for the quarter into their price and volume components. In effect, the results generally show higher prices and lower volumes than we expected for the quarter itself but do fit with our general thinking that 2017 is shaping up to be a year of slower GDP growth with higher inflation compared to 2016.

Real GDP growth might well be a bit slower near term, but nominal incomes are being boosted by higher terms of trade. The balance might well prove positive. That certainly seems to be the assessment of local businesses judging by yesterday's upbeat survey.

In the bigger picture, the indirect effects of the income boost from higher terms of trade on the economy are worth thinking about. It ultimately provides options:

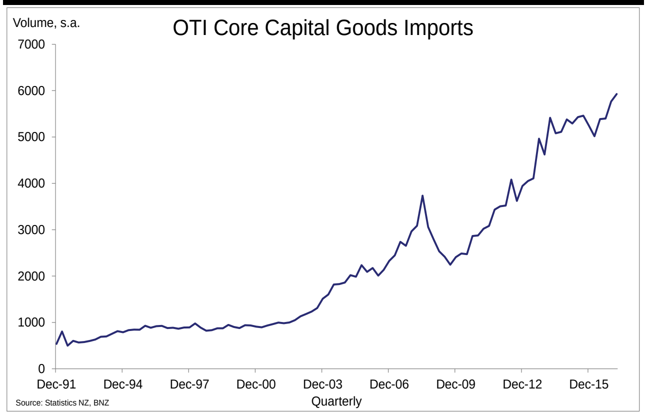
• Spend it – we've already seen some signs of this with very strong retail sales in Q1, including a strong pickup in sales outside the main centres of Auckland, Wellington and Canterbury as higher primary product prices support incomes. Some farm spending indicators have turned positive, although not aggressively so to date.

• Invest it – the pre-conditions are certainly there for more investment judging by yesterday's business confidence survey showing high capacity utilisation, rising profit expectations and stronger intentions to invest. Today's figures are encouraging with core capital import volumes up 2.8% in Q1, to be up 18.1% on a year ago.

• Save it – it is always difficult to isolate one factor's influence on saving, across all its possible forms. But the sharp slowing in agricultural debt expansion over recent times is noticeable as dairy farmer cash flows improve and some debt repayment comes onto the agenda.

Of course, it is very difficult to precisely isolate the influence of higher terms of trade across the various facets of the economy. But, overall, we think the boost to nominal incomes will support spending, saving and investment ahead. Our forecast suggests the mix of those will see reasonable growth as well as some further narrowing in the current account deficit in 2017. Higher terms of trade also helps lift the tax base, a plus for the fiscal accounts.

Investment Rising



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