RESEARCH

ECONOMY WATCH

1 December 2017

Record Terms

- **Merchandise terms of trade hits all time high**
- **But is expected to ease back from here**
- **Trade volumes offer Q3 GDP support**
- **Imported deflation ending?**

The terms of trade rose 0.7% in Q3 2017, to be 12.3% higher than a year ago. This was a little softer than market (and our) +1.3% expectations but not a big miss in the scheme of things. The terms of trade movement was the result of export prices (-1.9%) falling by less than import prices (-2.6%) in the quarter. Both trade prices underwhelmed, but we think reversal is in store for Q4 as a lower NZD takes effect.

Regards volumes, exports rose 0.3% and imports fell 0.7% in the quarter. Exports were a little stronger than we expected, while imports were a little softer. The net balance offers a bit more support to Q3 GDP that we had figured. But we see this as offsetting some downside risk that was around our 0.7% forecast for Q3 GDP, rather than a reason to revise up.

In the bigger picture, as we have been forecasting for more than a year now, the merchandise terms of trade has reached a record level in 2017, surpassing the previous peak in 1973 and higher than the Korean War-inspired surge in the early 1950s when wool prices spiked. It's important. A record terms of trade means that the purchasing power of the nation's exports is at its highest level ever. It is a big support to domestic incomes and assists all manner of things from economic activity, profit and wage increases, to savings and better balance in the fiscal and external accounts.

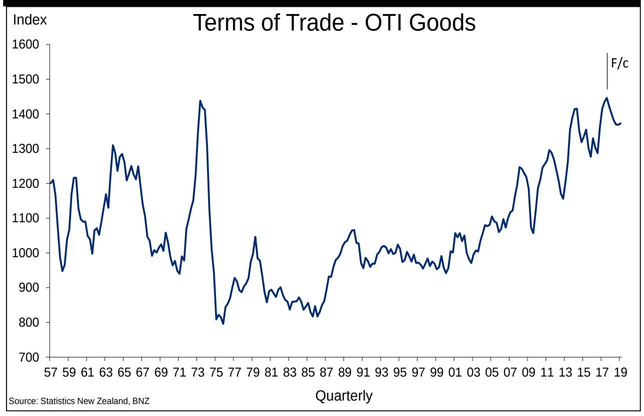
But we think this is as good as it gets for now. While we think the terms of trade will remain elevated relative to history, we believe it will start tracking a bit lower from here, initially reflecting lower dairy prices and higher oil prices offshore. This is part of a general easing we see through 2018, as export prices are expected to edge a little lower while import prices push mildly upwards.

The potential for somewhat higher import prices ahead is important given they would represent a drag on growth while pushing up inflation. This is no given. But if it were to transpire, it would exacerbate a similar dynamic brewing domestically via some cost-push inflation that we detected in yesterday's business confidence survey.

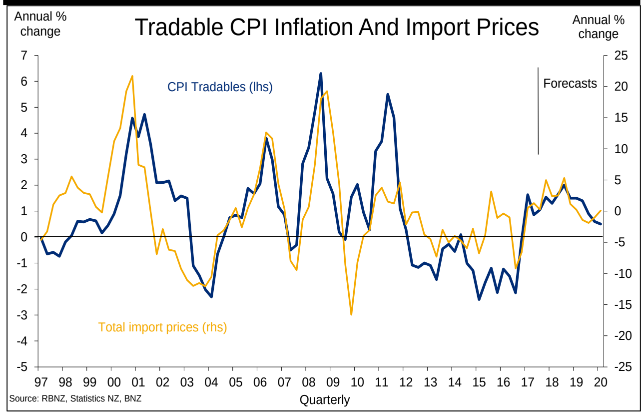
The trajectory of import prices from here bears watching, given their influence on CPI tradable inflation. Indeed, in its November MPS, the RBNZ ran a scenario of higher import prices that saw the cash rate around 100 basis points higher. After 5 years of persistently negative annual import price inflation, import price inflation has turned a touch positive in 2017. At 0.3% in Q3 2017 it is hardly strong, but it is significantly higher than the 9.2% deflation recorded a year earlier. Our current forecasts anticipate annual import price inflation will push up to around 5% in Q4 2017 and average just under 3% over the coming year on higher crude oil prices and a generally lower NZD. It forms part of our thinking that CPI annual tradable inflation will maintain its recent foray into mild positive territory through 2018.

doug_steel@bnz.co.nz

Record High



Import Price Pass Through



Contact Details

BNZ Research

Stephen Toplis
Head of Research
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Senior Economist
+64 4 474 6923

Jason Wong
Senior Markets Strategist
+64 4 924 7652

Main Offices

Wellington
Level 4, Spark Central
42-52 Willis Street
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Toll Free: 0800 283 269

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Toll Free: 0800 283 269

Christchurch
111 Cashel Street
Christchurch 8011
New Zealand
Toll Free: 0800 854 854

National Australia Bank

Peter Jolly
Global Head of Research
+61 2 9237 1406

Alan Oster
Group Chief Economist
+61 3 8634 2927

Ray Attrill
Head of FX Strategy
+61 2 9237 1848

Skye Masters
Head of Fixed Income Research
+61 2 9295 1196

Wellington

Foreign Exchange	+800 642 222
Fixed Income/Derivatives	+800 283 269

Sydney

Foreign Exchange	+61 2 9295 1100
Fixed Income/Derivatives	+61 2 9295 1166

London

Foreign Exchange	+44 20 7796 3091
Fixed Income/Derivatives	+44 20 7796 4761

New York

Foreign Exchange	+1 212 916 9631
Fixed Income/Derivatives	+1 212 916 9677

Hong Kong

Foreign Exchange	+85 2 2526 5891
Fixed Income/Derivatives	+85 2 2526 5891