BUSINESS NZ

PLANNING FORECAST

DECEMBER 2012

BusinessNZ

NZ Economy – pockets of optimism

Executive Summary

It is easy to fall into the trap of adopting an unduly pessimistic outlook on the prospects for the NZ economy given the continued flow of negative news coming out of a number of major developed countries. Sentiment in Europe remains negative, while in the US the need to address deficit projections through both tax increases and expenditure cuts will further impact on growth projections. Nevertheless, that country has little choice left.

Aggregate domestic data suggest a rather flat economy and tend to mask pockets of optimism in respect to the Christchurch rebuild and the wider housing market, particularly in Auckland.

Notwithstanding an increasingly subdued global outlook, there are underlying factors which should act in New Zealand's favour over the medium term.

Data coming out of China have improved of late with growth in output continuing at a reasonable clip.

A recent white paper from the Australian Government, entitled *"Australia in the Asian Century"* (October 2012), highlights a number of trends, including the fact that within a few years Asia will not only be the world's largest producer of goods and services but also its largest consumer. Moreover, it will be home to the majority of the world's middle class.

Another recent paper by the Organisation for Economic Cooperation and Development (OECD) entitled *"Looking to 2060: A Global Vision of Long-term Growth"* considers that divergent long-term growth patterns will lead to radical shifts in the relative size of economies. The United States is expected to cede its place as the world's largest economy to China, as early as 2016. India's GDP is also expected to pass that of the United States over the long term.

These trends will continue to bode positively for New Zealand's exporters over the medium term, particularly given a vast population base with individuals open to consuming greater quantities of the quality protein which New Zealand can supply.

While the medium term outlook for New Zealand is improving, short-term, things continue to look decidedly flat.

The latest BNZ-BusinessNZ Performance of Manufacturing Index (PMI) - for October 2012 - shows that, overall, activity is flat-lining in the manufacturing sector. On the other hand, the Performance of Services Index (PSI) showed a welcome jump in activity compared with recent months.

While business and consumer confidence continues to remain in positive territory, the focus of both businesses and households is firmly on retiring debt.

HIGHLIGHTS

The BusinessNZ Economic Conditions Index (ECI) sits at 8 for the December 2012 quarter, up 9 on the previous quarter and up 3 on a year ago.

The overall global economic growth outlook remains relatively benign. However, the increased influence of Asia both in terms of exports and a demand for protein from its increasing middle class is positive news for NZ exporters over the medium term.

Patchy growth is the order of the day in NZ with the housing market showing positive signs of life and the Christchurch rebuild starting to gain momentum.

Employment growth is clearly evident in Christchurch but elsewhere results are flat-lining.

While business and consumer confidence is on the positive side of the ledger, households and businesses continue to take a cautious approach to new investment with debt reduction still a high priority.

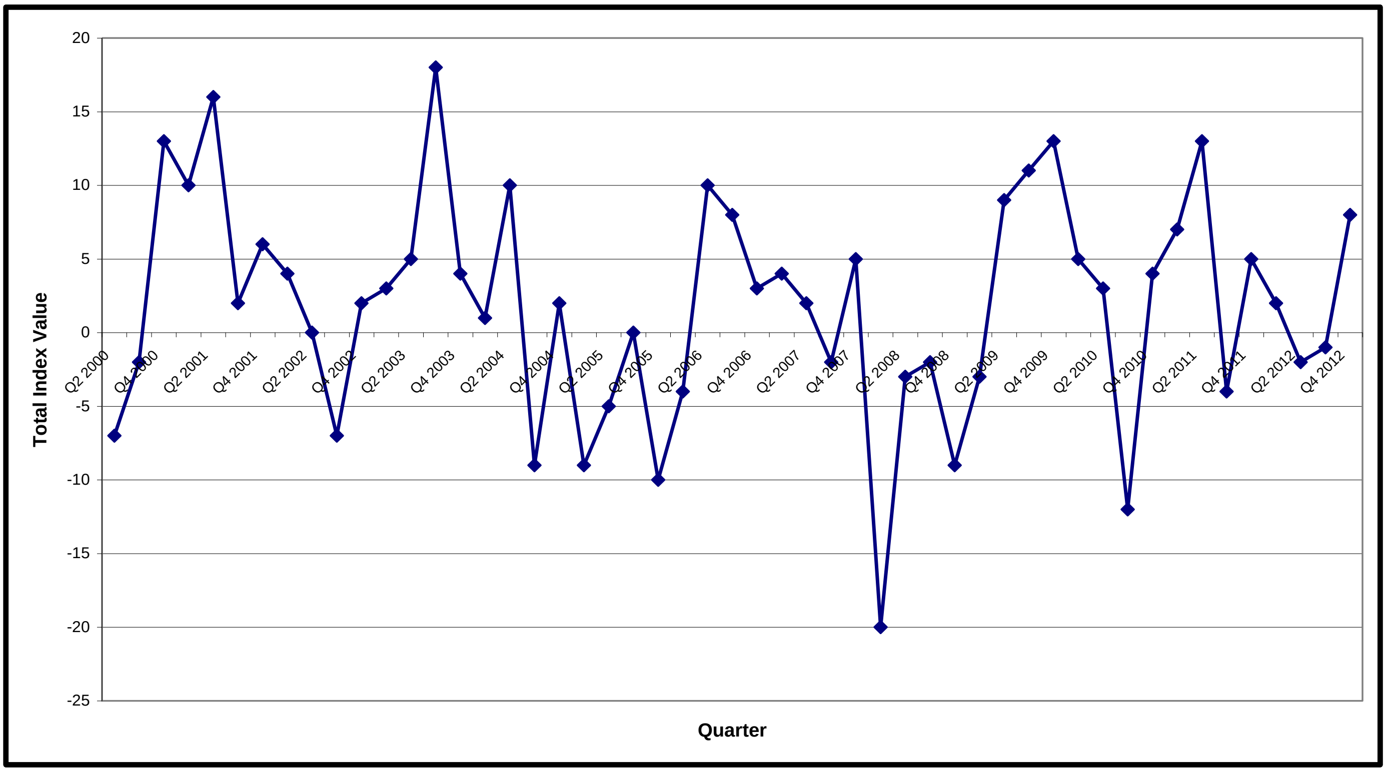
A low inflationary outlook is keeping interest rates at historic lows with no prospect of increases over the short to medium term.

PART 1: THE NEW ZEALAND ECONOMY – WHERE ARE WE NOW?

BusinessNZ Economic Conditions Index (ECI)

The overall BusinessNZ Economic Conditions Index (a measure of the major economic indicators) sits at 8 for the December 2012 quarter, up 9 on the previous quarter and an improvement of 3 on a year ago.[1]

Overall Economic Conditions Index (ECI)



Source: BusinessNZ

Data in the ECI is broken into four key sub-groups:

- Economic growth/performance indicators
- Monetary policy/pricing indicators
- Business/consumer confidence indicators
- Labour market indicators

In terms of the ECI sub-groups:

Economic growth/performance indicators sit at -2 for the December 2012 quarter, down 2 on the last quarter and down 8 on a year ago. Despite a relatively high NZ dollar compared with that of the US, commodity prices, both in international dollars terms and also when converted to NZ dollars, have improved of late showing that demand in our key export markets is holding up reasonably well despite a much weaker global growth outlook.

Monetary policy/pricing indicators sit at 0 for the December 2012 quarter, up 1 on the last quarter and down 2 on a year ago. The introduction of unorthodox monetary policies in the major economies e.g. the US, continues to put upward pressure on the NZ dollar. Inflationary pressures in NZ remain subdued, with historically low interest rates likely to continue over the medium term.

[1] The ECI tracks 32 indicators on a quarterly basis. The overall index value for any particular quarter represents the net balance of the 32 indicators (generally the number increasing minus the number decreasing) thus providing an overall measure of performance. In general, increases in an indicator are seen as positive (e.g. growth in GDP or employment) and declines as negative. However, this is not always the case. For example, declines in unemployment are seen as positive and increases as negative.

Business/consumer confidence indicators sit at 5 for the December 2012 quarter, up 4 on the previous quarter and up 6 on a year ago. Business confidence shows pockets of optimism but is still broadly subdued when looked at the economy as a whole.

Labour market indicators sit at 5 for the December 2012 quarter, up 6 on the previous quarter and up 7 on a year ago. The latest Household Labour Force Survey (September quarter 2012) was a fly in the ointment with unemployment increasing to 7.3 percent. Given concerns expressed over recent years by a number of commentators, including BusinessNZ, with the yo-yo effects of the HLFS, not too much should be read into this "one-off" result.

PART 2: THE NEW ZEALAND ECONOMY – WHERE ARE WE GOING?

1.1 Economic growth (GDP) – patchy

Economic growth is forecast to remain around 2.5 percent per annum out to December 2014, as outlined below.

Forecasts: Real GDP % Growth

	Years Ending		
	Dec 12	Dec 13	Dec 14
Highest	2.5	3.2	3.3
Average	2.5	2.7	2.6
Lowest	2.5	2.2	1.6

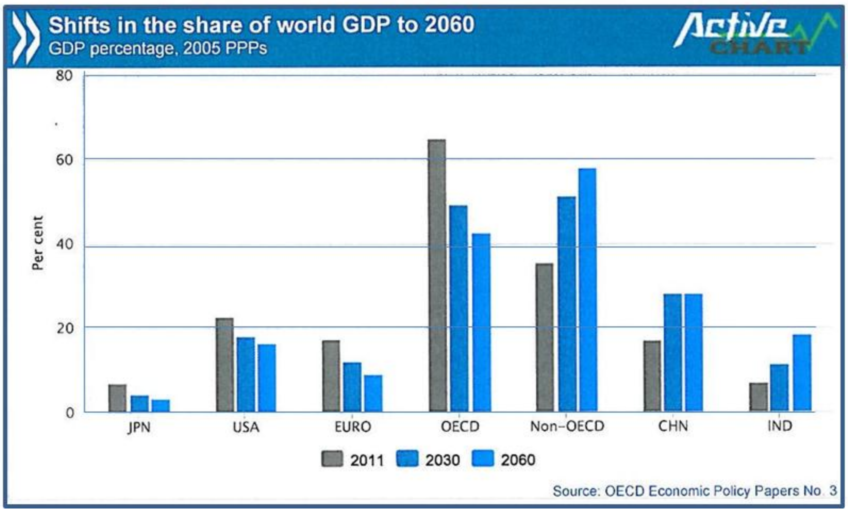
Source: ANZ, ASB, BNZ, National, and Westpac

Such forecast growth rates need to be put in context. While many developed countries are currently experiencing negative growth or mediocre growth at best, New Zealand's prospects by comparison are quite good.

Certainly, 2.5 percent growth is hardly startling but compared with other developed nations our key economic indicators are still the envy of many, including sovereign debt levels, the Government's fiscal position, unemployment rates and so on. Moreover, New Zealand has an advantage over many countries through the reform process undertaken over the last 25 years or so, focusing on a more competitive economy and ensuring sound monetary and fiscal institutions and sound regulatory policies. While there is always room for improvement, particularly in respect to the quality of regulation, sound frameworks have avoided the need for NZ to go down the largely untested and radical routes some countries have taken post the GFC, as, for example, in respect to monetary policy settings.

There are a number of factors which could impact positively on NZ's growth prospects over the coming year or so.

First, as mentioned in the executive summary, New Zealand is well placed to take advantage of the increased focus on Asia given that Asia will not only be the world's largest producer of goods and services but also its largest consumer. More importantly, it will be home to the majority of the world's middle class.



Despite, concerns about the global economic outlook, New Zealand is currently providing goods and services to countries where growth prospects continue to be high, particularly China.

The latest results from the ANZ Commodity Price Index show that prices have increased for the third consecutive month, with an increase of 1.3 percent in October compared with the previous month. The index has recovered 5 percent from its recent July low but is still 16 percent off the all-time high recorded in April last year.

While the value of the NZ dollar continued to firm slightly in October against the US dollar - with some impact on prices when converted into NZ dollars - the ANZ NZD Commodity Price Index still recorded a 1.1 percent rise.

ANZ Commodity Price Index

	World Price Index	Annual % Change	NZ$ Index	Annual % Change
Oct 2008	217.7	-11.2	197.6	7.9
Oct 2009	213.1	-2.1	158.8	-19.6
Oct 2010	269.5	26.5	196.0	23.4
Oct 2011	291.7	8.2	201.8	3.0
Oct 2012	266.5	-8.7	176.5	-12.5

Source: The ANZ Commodity Price Index – 2 November 2012

Second, the rebuild of Christchurch, which, after significant delays, appears to be gathering momentum as outlined in a number of official and unofficial statistics. Beyond Christchurch there is also significant improvement in the housing market, particularly in Auckland as several years of pent up demand for housing are now being reflected in greater construction activity. Earthquake strengthening of buildings, notably in Wellington, will also be an ongoing source of activity for a number of years to come.

Third, the Government's desire to unlock some of the mineral wealth in New Zealand will provide further opportunities for growth.

Fourth, the Government's commitment to improving access to natural resources and providing greater security as to the rights and obligations of resource users will assist business development and economic growth over the medium term. In this respect, the recent third report of the Land and Water Forum (LWF) is a welcome contribution to improving freshwater management.

Water is essential to a wide variety of business activities which drive New Zealand's economy and on which many New Zealanders rely for employment and income growth.

Businesses require the confidence to invest in infrastructure and other capital projects knowing their rights to use water are clearly understood and secure.

It will be fundamental to any successful freshwater management regime that the transfer and trade in water rights is facilitated to the extent possible allowing water to move to its highest valued use, without unnecessary restrictions from regulators.

It will also be crucial that all 67 recommendations of the LWF report are adequately stress-tested to ensure each contributes to a robust freshwater management regime which stands the test of time.

1.2 Monetary Conditions – little change in prospect

Interest rates – no change

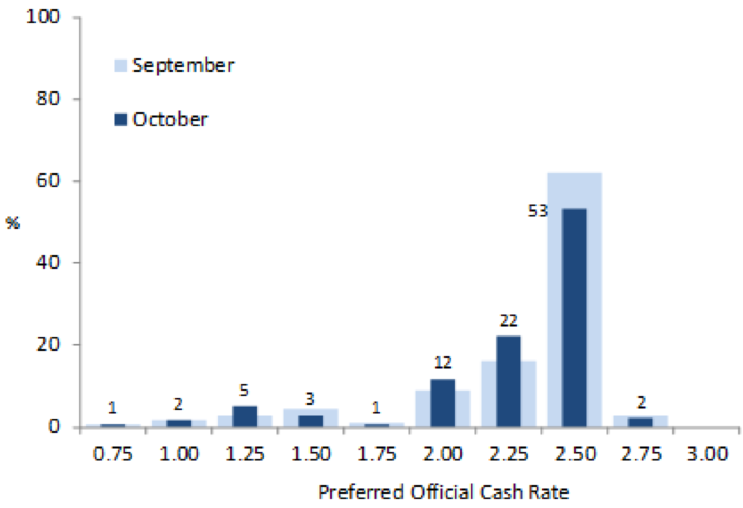
The 90-day bill rate is forecast to increase slowly to reach 3.3 percent by December 2013 and 4.3 percent by December 2014, as evidenced in the forecasts below.

With inflationary pressures (and expectations) at historic lows, the likelihood of any interest rate rises in the foreseeable future is very slim. There is an equally slim chance of an interest rate cut, given that the Reserve Bank will be mindful of keeping something in reserve should things get really bad and of the potential for inflationary pressures to build over time, as outlined earlier. Many overseas countries have already "shot the bolt" in respect to interest rate cuts, with rates in some countries now at zero or close to zero. Consequently, some are looking at radical and unorthodox approaches to monetary policy but so far with little positive result.

As a wide range of economists generally expected, after the recent review – the first under the new Governor of the Reserve Bank, Graeme Wheeler - the OCR remained unchanged. However, a number of commentators considered there was possibly scope for a small cut, although it is highly debatable as to whether such a cut would have taken any pressure off the exchange rate, given that principally, the relatively high NZ dollar is driven by activity overseas rather than by anything domestically which can be tweaked.

The New Zealand Institute of Economic Research's (NZIER) Shadow Monetary Policy Board (whose task it is to recommend interest rate settings ahead of each decision by the Governor of the Reserve Bank of NZ) found the majority still supported 'no change' to the Official Cash Rate (OCR) although it was a close call with reasonable support for a cut: *"Inflation is below the bottom of the band, the growth outlook for the second half of 2012 looks weak and unemployment remains stubbornly high. The exchange rate continues to be overvalued. Given these circumstances, overall the Shadow Board remains in favour of holding the OCR steady, but participants are placing greater weight on lower rates as the recovery fails to ignite."*

NZIER *Shadow Board* continues to favour an OCR of 2.50%



Source: NZIER ***Shadow Board***

Forecasts: Interest Rates (90 day bills)

	As at end of		
	Dec 12	Dec 13	Dec 14
Highest	2.8	3.5	4.8
Average	2.7	3.3	4.3
Lowest	2.7	3.2	3.8

Source: ANZ, ASB, BNZ, National, and Westpac

The New Zealand dollar – global uncertainty continues to reign

Forecasts below show the NZ dollar remaining very stable against the Australian dollar. It is expected to remain at evaluated levels against to the $US out to December 2013 and then fall away somewhat.

Forecasts: Exchange Rates

AUD (cents)			
	Dec 12	Dec 13	Dec 14
Highest	0.820	0.796	0.800
Average	0.794	0.790	0.794
Lowest	0.777	0.780	0.778

USD (cents)			
	Dec 12	Dec 13	Dec 14
Highest	0.830	0.850	0.760
Average	0.818	0.810	0.736
Lowest	0.810	0.780	0.685

TWI			
	Dec 12	Dec 13	Dec 14
Highest	74.5	74.5	71.6
Average	73.4	72.7	68.8
Lowest	71.6	70.6	62.9

Source: ANZ, ASB, BNZ, National, and Westpac

One of the difficulties of forecasting exchange rates is that the game has changed over recent years with ad hoc interventions in international markets having detrimental impacts on currencies such as NZ's.

The incoming Governor of the Reserve Bank, Graeme Wheeler, made his views clear on what monetary policy could and could not do in an incoming speech entitled *"Central banking in a post-crisis world".* Mr Wheeler's speech clearly continued the orthodox approach of his predecessor by articulating that what monetary policy can deliver are price stability and a stable financial system. He made it clear that multiple objectives for the Reserve Bank, such as economic growth targets, would be beyond the ability of monetary policy to deliver.

Inflation - subdued expectations

Forecasts outlined below show inflation is likely to be well within the Reserve Bank's target range of 1-3 percent for the year to December 2013, although some pressure will start to build in 2014.

Headline inflation remains subdued for a range of reasons.

First, an elevated exchange rate again the $US is keeping any imported pressures at bay.

Second, a relatively subdued global economic outlook is taking pressure off resources internationally (e.g. oil).

Third, a subdued labour market outlook is taking any pressure off wage rises.

Fourth, strong competition in the domestic market has resulted in profit margins being slashed with many businesses relying on heavy discounting in order to move stock. Retail sales remain sluggish.

There will be some potentially upward pressures on construction costs as a result of an increased demand for labour from both the rebuild of Christchurch and housing growth in Auckland. Reviews of building codes will add to costs facing businesses as prime ("earthquake resistant") building rentals potentially increase significantly. Obviously, insurance costs will also rise which will be an issue of both businesses and households wherever they are in NZ. These costs collectively will put upward pressure on the CPI.

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Dec 12	Dec 13	Dec 14
Highest	1.3	2.5	3.3
Average	1.3	2.2	2.7
Lowest	1.1	1.9	2.4

Source: ANZ, ASB, BNZ, National, and Westpac

1.3 Business and consumer confidence – hanging in there

Business confidence – no real change

Business confidence has more-or-less plateaued since mid-year. Although confidence is still in positive territory, it has tended to flat line of late, as evidenced by a number of business opinion surveys.

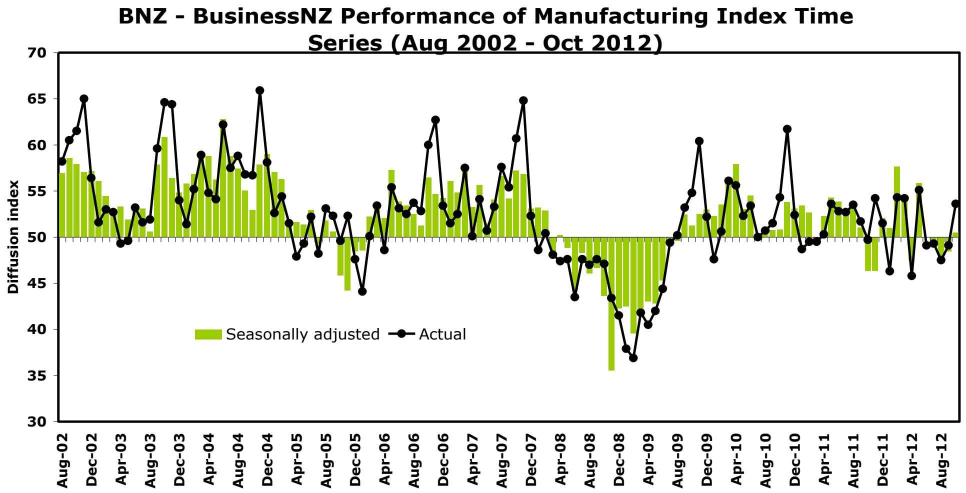
The ANZ Business Outlook shows that a net 17 percent of respondents expect business conditions to improve over the year ahead, the same reading as in September.

While more importantly, firms' own activity expectations have held up reasonably well (a net 26 percent expecting more activity over the coming year, down slightly on the previous month), the overall trend (if there is one) is effectively a subdued business sector but bouncing around on a monthly basis. The latest results underpin an economy where 2-3 percent growth is probably the best that can be expected over the medium term, which in the context of global growth is still pretty good.

Many business opinion surveys are showing the same yo-yo effect occurring in other data, both official and unofficial, such as the latest Household Labour Force Survey (HLFS), and to some extent the BNZ-BusinessNZ Performance of Services Index (PSI).

The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) showed minor expansion in October, although the sector remains in a flat state.

The seasonally adjusted PMI for October was 50.5 (a PMI reading above 50 points indicates manufacturing activity is expanding; below 50 indicates it is contracting). This was 2.0 points up from September and the first level of expansion after four consecutive months of no expansion.



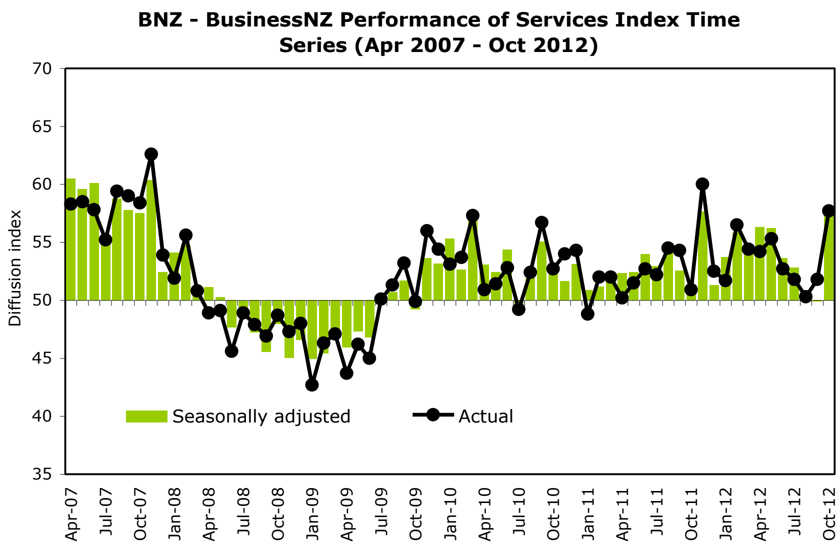
Source: BusinessNZ

Three of the five seasonally adjusted main diffusion indices were in expansion in October. This was led by production (53.8), which experienced its highest result since May, followed by finished stocks (52.1), displaying its highest value since August 2011. After consecutive falls in activity, new orders (50.9) managed to return back into slight expansion for October, while both employment (49.1) edged lower and deliveries (49.7) improved, albeit having remained in contraction for the last five months.

The seasonally adjusted PSI for October 2012 was 57.4, up 7.5 points from September, and the highest result since November 2011. Compared with the previous October's results, the 2012 value was the second highest recorded since 2007.

While not too much should be read into the result for one month, it does reinforce the potential for a first step towards a rebound from the soft data coming out earlier in the year.

For the record, all five main sub-indices were in expansion during October. Activity/sales (64.2) led the way with its highest result since the survey began in 2007. Likewise, new orders/business (62.7) recorded its highest value since November 2007, although almost on par with its result in May this year. Employment (52.1) returned to activity levels last seen in July, while supplier deliveries (54.7) also bounced back from three months in contraction. Finished stocks (51.0) was the only sub-index to experience a fall in expansion levels during October, although consistent with results over the last six months.



Source: BusinessNZ

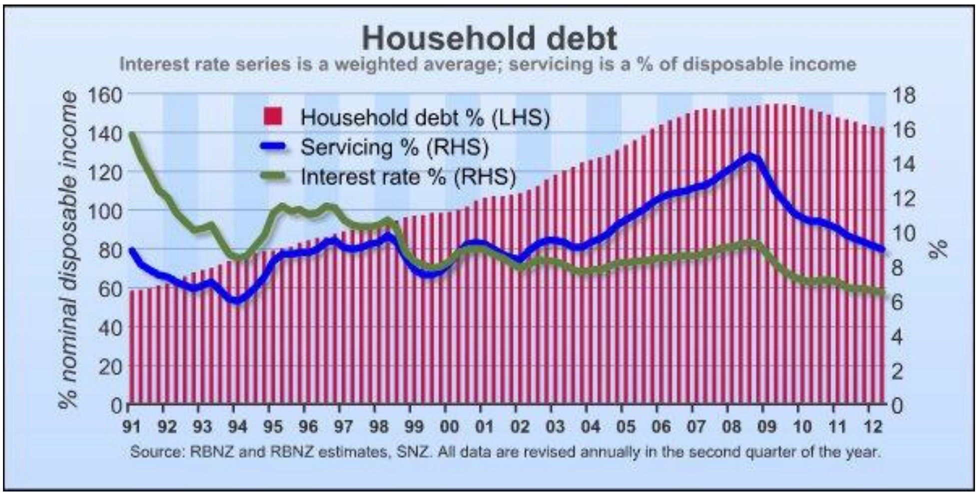
Other sectors remain mixed. Residential and commercial construction is showing signs of improvement on the back of strong demand in Auckland, and the continuing rebuild of Christchurch. Housing consent numbers for September 2012, compared with September 2011, were up 22 percent (1,520 new houses including apartments).

The reasonably long period of brightness for the agricultural sector is losing some of its lustre with the agricultural industry in general feeling decidedly more pessimistic than in the recent past. However, the results need to be taken with a grain of salt.

International commodity prices are still reasonably solid (and have improved of late), despite coming off their heights over the last year or so. There may be a fear that agricultural producers face increased regulation (e.g. in the environmental space) which could be promoting some tension and disquiet. However, the outlook for agricultural production over the medium term, is, in our view, much brighter than opinion surveys would have us believe. The opportunities for continued growth into Asia in particular, provide NZ producers with a solid platform on which to expand production and hopefully prices.

Consumer confidence – still fragile

Consumer confidence remains in positive territory but results show an underlying theme of continuing caution with a strong focus on debt reduction. Debt reduction is being assisted by historically low interest rates, with little chance of interest rate hikes given a general lowering of inflationary expectations.



The ANZ-Roy Morgan NZ Consumer Confidence measure firmed to 114.1 in November from 110.5 in October. After accounting for seasonal factors, overall confidence gained 3 points (to 112.7) to sit around July/August levels. There is clearly no evidence of a trend upwards in confidence.

Given consumer confidence is closely related to current and future employment prospects, the drifting nature of labour market outcomes at the moment is perhaps adding to the caution evidenced in recent consumer behaviour.

Retail sales and electronic transactions remain flat, although the housing market is starting to gain momentum, particularly in Christchurch and Auckland, where shortages (for different reasons) are driving up prices and encouraging new construction activity.

1.4 Labour market – yo yo continues

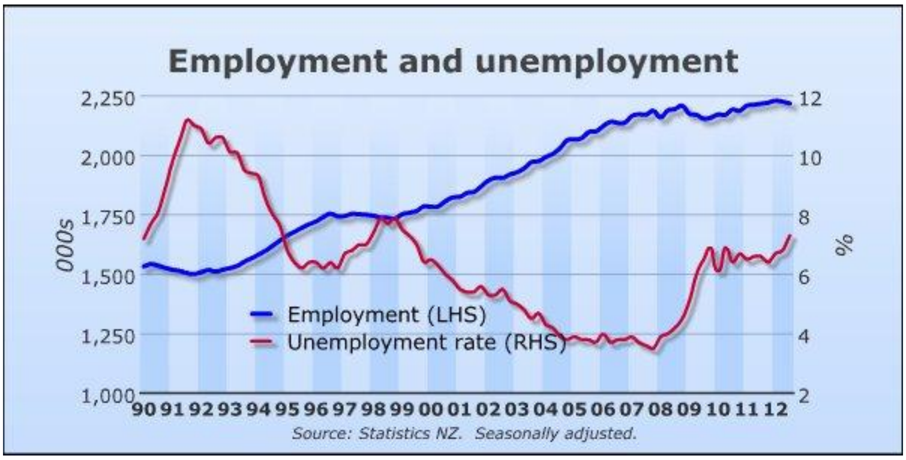
Employment – drifting sideways

Forecasts show that unemployment is expected to drift lower over the next 2 years to reach 5.7 percent by December 2014 (see below). This might be a tough ask if current official data are anything to go by.

The latest Household Labour Force Survey (HLFS) for the September quarter 2012 shows a jump in the unemployment rate from 6.8 percent to 7.3 percent, along with a drop in employment of 9,000.

As we have said before, the quarterly unemployment results of the HLFS, particularly over the last 3-4 years, have tended to provide a rather saw-tooth result when plotted on a graph, as can be seen below. To be sure, a number of indicators, including the BNZ-BusinessNZ PMI and PSI showed that employment growth was in the doldrums over the September quarter, but no-one predicted the 9,000 drop in jobs.

The latest PMI and PSI (for the month of October) show that employment in both the manufacturing and services sectors is reasonably static. The PSI employment index is slightly in positive mode (52.1) while the PMI remains slightly in contraction (49.1).



Other forward-looking surveys of employment confidence, including the ANZ's Job Adds series and the Westpac McDermott Miller Employment Confidence Index, show a drifting labour market rather than any clear signs of the labour market going backwards. The HLFS results appear to be out of line with most other indicators of labour market activity. In this respect, the September HLFS results need to be taken with a healthy grain of salt.

The ANZ Job Ads for October 2012 shows a slight fall in Job Ads (0.8 percent) from the previous month. However, this follows on from a 3 percent drop in September. Canterbury job ads fell in October but continue to trend higher, while other regions remain flat to falling. Overall, Job Ads appears to be reasonably static, suggesting that the unemployment rate is likely to remain at the high end of 6 percent for the next 6 months or so.

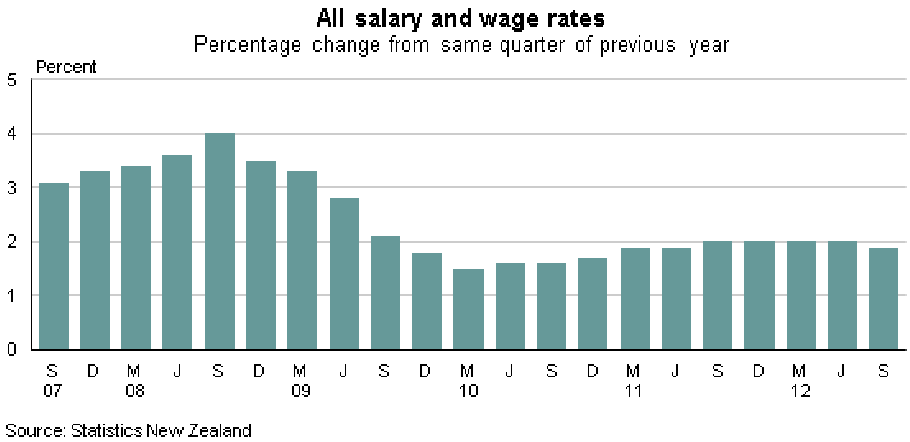
Forecasts: Unemployment % (HLFS)

	Quarter		
	Dec 12	**Dec 13**	**Dec 14**
Highest	**7.0**	**6.3**	**6.2**
Average	**6.9**	**6.2**	**5.7**
Lowest	**6.6**	**6.1**	**5.3**

Source: ANZ, ASB, BNZ, National, and Westpac

Labour costs – stable

Given a rather benign outlook for labour market activity it is not surprising that forecasts below indicate that labour costs are expected to increase only slowly to around 2.4 percent for the year ending September 2014. This is very much in line with the long-run average for the Labour Cost Index and up slightly on recent annual increases which have averaged around 2 percent. Forecasts largely reflect the slight pick-up expected in labour market outcomes predicted over the medium term.



Private sector salary and wage rates (including overtime) increased 2.1 percent in the year to the September 2012 quarter. Public sector salary and wage rates (including overtime) increased only 1.4 percent in the year to the September 2012 quarter. The latest annual wage growth in the public sector resulted in growth in central government (up 1.3 percent) and local government (up 2.3 percent).

While there will undoubtedly be some upward wage pressures in particular sectors (e.g. in the trades sector and associated services involved in the Christchurch rebuild), not surprisingly, given the general state of the labour market, overall wage pressures appear to be modest.

Forecasts: Labour cost index percentage change (wages & salaries)

	Years ending		
	Dec 12	**Dec 13**	**Dec 14**
Highest	**1.9**	**2.7**	**2.8**
Average	**1.8**	**2.1**	**2.4**
Lowest	**1.7**	**1.6**	**2.2**

Source: ANZ, ASB, BNZ, National and Westpac