BUSINESS NZ

PLANNING FORECAST

JUNE 2010

BusinessNZ

NZ economy on the rise

Executive Summary

New Zealand is poised to take advantage of an improving international market outlook with commodity prices going from strength to strength.

Despite ongoing concerns with debt levels in some developed countries and difficulties with Governments winding back expenditure programmes in light of public expectations, many emerging economies and parts of Asia, are booming with double digit growth.

China, now New Zealand's second largest trading partner, behind Australia, continues to show strong growth, while Australia is also showing strong expansion on the back of a continuing demand of minerals. While the mining industry may suffer a temporary setback on the back of the Australian Government's decision to introduce a special "super profits" tax on minerals, the growth of the Australian economy overall augurs well for continued export growth to that country.

Significantly improved commodity prices have been reflected in a major drop in New Zealand's current account deficit of late and have resulted in an annual trade balance surplus of $161 million for the year ended April 2010. This is the first annual trade surplus recorded since July 2002.

Household budget will be boosted later this year through the implementation of significant personal income tax cuts announced in the recent budget. While the tax cuts were generally more significant than many commentators considered likely, both households and businesses will face some added costs which will reduce the tax cuts' real disposable value. Some of these costs include the one-offs associated with a rise in GST to 15%, the removal of the depreciation loading and the proposed rules surrounding non-depreciation for new buildings which have an expected life of greater than 50 years. Obviously their implications will differ from household to household and business to business.

Notwithstanding the above, the government has been relatively generous in offsetting the effects of GST increases on beneficiaries and those receiving NZ Superannuation, so in reality, only a relatively few people (including businesses) will be any worse off as a result of the tax changes taken as a whole.

Given the Government's ongoing commitment not to touch significant expenditure areas such as the age of eligibility for NZ Superannuation, interest free student loans, or the fundamentals of the Working for Families scheme, the Budget represented a significant attempt to realign incentives (particularly within the tax system), while maintaining responsible levels of debt. Its efforts will be the envy of many countries to which we traditionally compare ourselves.

HIGHLIGHTS

Business New Zealand's Economic Conditions Index (ECI) is currently at its highest level since the third quarter of 2003 which augurs well for future economic and employment growth.

The international economy, while still mixed, has largely recovered from the recession of two years ago. However, debt levels remain the Achilles heel for a number of developed economies as Governments struggle to rein in public expectations with reality.

While some official statistics on the NZ economy continue to show mixed results, forecasts from the key forward looking indicators are all generally positive.

The Government's recent budget will have helped to improve both business and consumer confidence on the back of significant personal income tax cuts while containing debt burdens within manageable levels. The drop in the company tax rate to 28% was largely unexpected and may offset the tightening up in the rules around building depreciation.

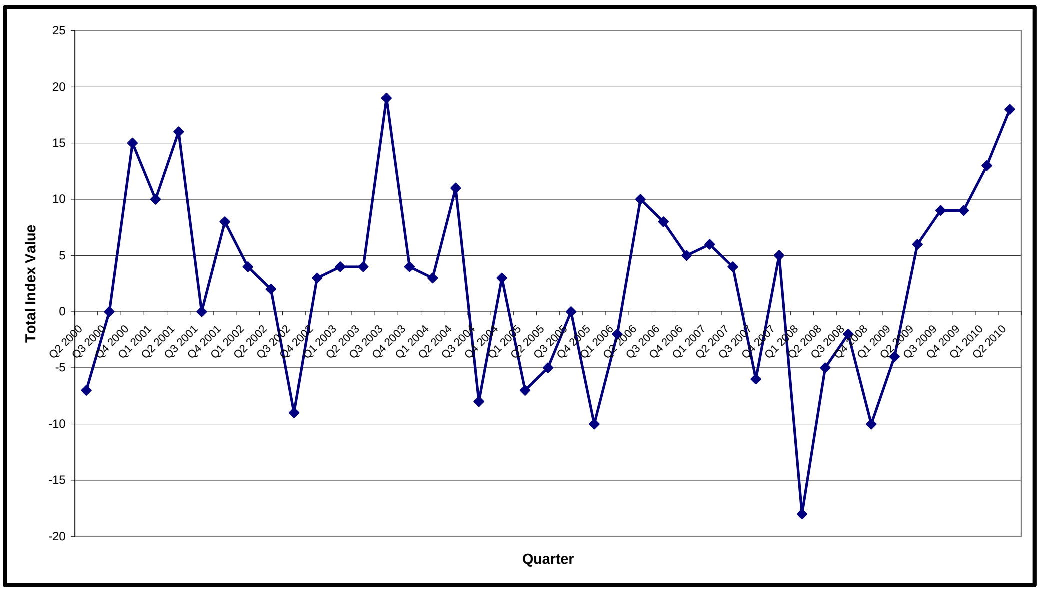
The one fly in the ointment remains the potential for ongoing inflationary pressures with the CPI headline rate projected to reach 5.9 percent next year as a result of a number of "one-offs" e.g. rise in tobacco excise tax, the increase in the rate of GST to 15%, the introduction of the Emissions Trading Scheme (ETS) and a rise in ACC levies for motorists. While the Reserve Bank will ignore "one-offs" in setting monetary policy, the danger is that individuals and businesses will react to them.

Part 1: The NZ Economy – Where are we Now?

Business NZ Economic Conditions Index (ECI)

The overall Business NZ Economic Conditions Index (a measure of the major economic indicators) sits at 18 for the June 2010 quarter, up 5 from the previous quarter and up 12 on a year ago. The ECI is now at its highest point since the third quarter of 2003[1]

Overall Economic Conditions Index (ECI)



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 8 for the June 2010 quarter, the same as the last quarter and a significant improvement on the 0 result as at June 2009. Tentative growth from mid-2009 is now being transformed into much stronger growth as world demand increases. This is evidenced by a strong growth in commodity prices which is impacting positively on NZ's terms of trade and current account balance.

[1] The ECI tracks 33 indicators on a quarterly basis. The overall index value for any particular quarter represents the net balance of the 33 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.

Monetary policy/pricing indicators sit at -3 for the June 2010 quarter, down 2 on the March 2010 quarter and down 6 on a year ago. Rises in interest rates just around the corner and inflationary pressures building largely as a result of "one-off" cost increases flowing through into headline inflation will likely see this sub-group remain in negative territory for some time.

Business/consumer confidence indicators sit at 7 for the June 2010 quarter, up 4 on the March 2010 quarter and the same as a year ago. High levels of business and consumer confidence over the past year are finally being reflected in greater investment as businesses rebuild stocks and increase capacity for future growth. Consumers are likely to be even more buoyant on the back of the recent Budget announcement of impending personal income tax cuts.

Labour market indicators sit at 6 for the June 2010 quarter, up 3 on the March 2010 quarter and up 10 on a year ago. While official labour market statistics have bounced around markedly over the last six months, the evidence is now clear. Relatively strong growth in employment is evident boding well for steady declines in unemployment over coming months.

Part 2: The NZ Economy – Where are we going?

1.1. Economic growth (GDP) – On a clear upward path

Projections are for modest growth of around 3.5 percent for the years ending June 2011 and 2012 as outlined below.

Forecasts: Real GDP % Growth

	Years Ending		
	June 10	June 11	June 12
Highest	1.3	4.7	4.0
Average	0.9	3.5	3.5
Lowest	0.6	2.6	2.8

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

There are a number of factors which should underpin growth over the next 3-5 years, giving confidence to both businesses and households to invest.

Sound financial system

Probably most importantly, New Zealand has a very sound financial system, underpinned by an equally transparent state sector.

A recent International Monetary Fund (IMF) review of the New Zealand economy concluded that the NZ economy rode out the global financial crisis better than most advanced economies, although the review did point to issues surrounding debt levels and potential currency overvaluation.

While NZ benefited from strong demand from fast-growing Asian markets and the continued robustness of the Australian economy, the IMF pointed to the benefits associated with a flexible exchange rate, the absence of any banking crisis, and the flexibility of government in addressing issues of fiscal and monetary policy.

Riding on growth of major trading partners

Despite continuing concern about the state of some developed countries, specifically debt levels, NZ is well placed to take advantage of strong growth opportunities in Asia, and particularly in China which is now our second largest trading partner behind Australia.

While NZ produces a minuscule amount of world GDP (estimate of around 0.2%), NZ is a significant player in terms of world trade in many agricultural commodities. NZ is responsible for around 35% of world trade in dairy products and is a significant player in terms of the international trade in sheep meat. Any upward moves in commodity prices obviously have significant implications for New Zealand

Fonterra have recently announced the opening forecast payout for the 2011 season at $7.10 – up on the current season's payout with some projections suggesting that $8/kg for milk solids (or more) is not out of the question. While obviously great news for NZ's terms of trade and current account deficit, it is likely that the Fonterra board will seek to retain any significant increase in the forecast payout beyond $8 as its seeks to keep debt levels well within a prudent range and also to safeguard against any future slump in international commodity prices.

The ANZ Commodity Price Index continues to soar, up a further 4.9 percent in April and underpinned by a 9.9 percent surge in dairy prices in the same month. The index now stands at 235.2, up a huge 53.0 percent on a year ago. Despite a slightly stronger NZ dollar in April, when converted into NZ dollars, the index still recorded a significant 3.8 percent increase for the month of April and a 23.3 percent increase on a year ago. Perhaps more importantly, the rise in commodity prices is largely across the board rather than on only one or two commodities. This reflects the general upswing in global demand, although as suggested above, some countries are still in deep trouble.

ANZ Commodity Price Index

	World Price Index	Monthly % Change	Annual % Change	NZ$ Index	Monthly % Change	Annual % Change
Apr 2006	149.2	1.6	-4.7	128.1	3.9	9.2
Apr 2007	180.4	4.9	20.9	133.9	-0.1	4.5
Apr 2008	217.7	-0.3	20.7	151.8	1.1	13.4
Apr 2009	153.7	2.6	-29.4	140.2	-2.7	-7.6
Apr 2010	235.2	4.9	53.0	172.8	3.8	23.3

Source: The ANZ Commodity Price Index NZ – May 2010

Budget 2010

The Government's tax reforms announced in the recent budget, particularly a lowering in the top personal income tax rate, and a drop in the company tax rate to 28 percent, will make NZ more competitive and give confidence to both businesses and households to invest in NZ. The crucial point that the Government needs to accept is that the recently announced tax reforms should not be seen as an end in themselves but as a useful start towards making NZ's tax system more internationally competitive, given the mobility of both international capital and labour.

A number of business and consumer confidence surveys show businesses' assessment of their own activity going forward is positive and hence provides some confidence that economic growth will follow. For example, the latest National Bank: Business Outlook – April 2010 shows that employment intentions rose with a net 16 percent now expecting to hire additional staff. This is the highest reading since April 2002, and is at a level which is consistent with around 4 percent employment growth.

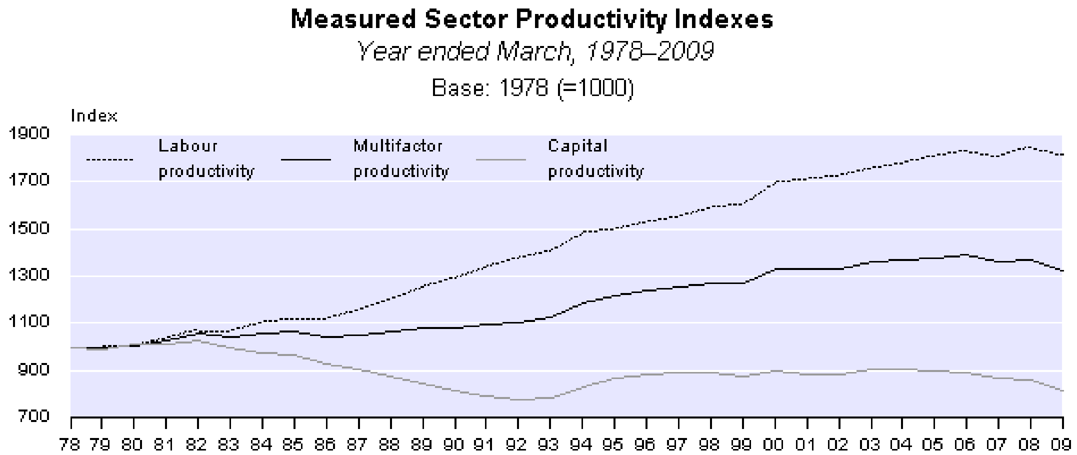
Budget disappointments

Perhaps the slightly disappointing factor in the budget was the lack of drive on the implementation of a Regulatory Responsibility Act. Transparent fiscal and monetary policies need support from equally transparent and rigorous regulatory policy decision-making.

Although a host of regulatory reform is currently occurring in respect to specific pieces of legislation/regulation, the two overarching changes that BusinessNZ and other groups continue to advocate for are the establishment of a NZ Productivity Commission and the introduction of a Regulatory Responsibility Act.

While the business community will be pleased to see that the productivity commission is to be established (as announced a while ago), there was no announcement about the re-introduction of a Regulatory Responsibility Bill, which means the current bill remains in limbo. The only comment in the budget was the statement that the Government intends to release a discussion document on ways to ensure that new and existing regulations are subject to proper scrutiny. Clearly greater effort is required to ensure regulatory reform is given centre stage in next year's budget, if not before.

An issue causing ongoing disappointment is the rate of productivity growth which is important given the importance of productivity to increasing our growth rate and hence improving New Zealanders overall standard of living.



Productivity is a measure of how efficiently inputs are being used within the economy to produce outputs. Growth in productivity means that a nation can produce more output for the same amount of input. Latest statistics available from Statistics NZ *"Productivity Statistics: 1978-2009" (16 March 2010)* show that labour, capital and multifactor productivity all fell over the 2006-09 period. Multifactor productivity (MFP) is measured as a ratio of outputs to total inputs. It can also be defined as growth that cannot be attributed to capital or labour, such as technological change or improvements in knowledge, methods, and processes.

Putting aside issues surrounding measurement problems, and the fact that the 'measured sector' only accounts for about three-quarters of the economy, the latest results continue to represent a relatively disappointing picture.

There are a number of potentially useful explanations for the continuing low productivity figures. One theory is that the utilization of capital capacity falls as demand slows, which would lead to a fall in output growth. Another arguable case is that a change in the skill composition of the employed labour force, due to skill shortages, may reduce the average productivity of the labour force. This is possible given the low unemployment rate until recently and a record high labour force participation rate. Other theories include the possibility of labour hoarding i.e. employers reluctant to dismiss staff for fear of having significant transaction costs of recruiting new staff when the economy picks up.

While there is likely to be an element of truth in all of the above points, perhaps the most concerning fact is that over recent years New Zealand's productivity record has continued to be mediocre. The trend line is clearly downward. This suggests that the above short-term theories are not necessarily valid when productivity is measured over the longer term. This makes it all the more important to address as many factors as possible which impact on productivity. Tax is only one such factor.

1.2 Monetary Conditions – Tightening inevitable

Interest rates – rise just round the corner

While the Official Cash Rate (OCR) remains at 2.5 percent it is increasingly clear that the rate will rise soon. Reasonably significant rises are likely with the 90 day bill rate forecast to increase to around 5 percent by June next year and slightly further into 2012 (see table below).

A much stronger economic outlook and the potential for inflationary pressures to persist (see below) are issues which will be concerning for the Reserve Bank in setting monetary policy.

While growth projections are to be welcomed, the Government has done little in a practical sense to rein in the big areas of government expenditure, while headline inflation, as measured by the CPI is forecast to hit 5.9 percent in 2011 before falling back to around 2.4 percent in the out years.

Core Crown expenses are forecast to increase from around 34.2 percent of GDP (current) to around 34.7 percent by 2011 declining thereafter to around 32.4 percent by 2014. While the increase in 2011 could be largely considered a result of "one-offs" such as compensation to beneficiaries as a result of GST increases and the timing of Treaty of Waitangi settlements, overall expenditure projections are still concerning, particularly given the ever increasing ageing population with implications for NZ Superannuation payments and healthcare expenditure.

Forecasts: Interest Rates (90 day bills)

	As at end of		
	June 10	June 11	June 12
Highest	3.2	5.2	6.2
Average	3.1	5.0	5.8
Lowest	2.7	4.6	5.2

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

The New Zealand Dollar – yo-yo currently and medium term still no certainty

The NZ dollar has come under some pressure recently given continued uncertainty in the EU and the rush back towards what are perceived to be safe havens (US dollar and Yen) rather than commodity based currencies. However, this will likely change as confidence internationally improves and investors flock back towards commodity based currencies.

Generally there is a tendency for commodity based currencies to follow the fortunes of commodity prices so all other things being equal, the NZ dollar may well appreciate further. On the other hand, the forecasts below show the clear uncertainty with projected currency movements over the medium term, with bank forecasts for the NZ/US cross rate fluctuating wildly over the next couple of years.

Only one thing is certain, and that is that no currency is totally immune from world economic events. In this respect, businesses must use available tools to try and manage that risk to their advantage but remembering that just like the risks attached to fixed or floating interest rate options, so too there are risks associated with hedging.

Forecasts: Exchange Rates

AUD (cents)			
	June 10	June 11	June 12
Highest	0.790	0.820	0.840
Average	0.774	0.800	0.806
Lowest	0.747	0.756	0.788

USD (cents)			
	June 10	June 11	June 12
Highest	0.740	0.750	0.710
Average	0.723	0.713	0.675
Lowest	0.710	0.680	0.650

TWI			
	June 10	June 11	June 12
Highest	68.5	70.4	70.1
Average	67.4	68.4	66.8
Lowest	65.0	64.9	65.0

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

Inflation - pressure will build

Forecasts outlined below show that inflation is widely tipped to be at the higher end of the Reserve Bank's target of 1-3 percent and actually breach the band next year.

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	June 10	June 11	June 12
Highest	2.2	4.9	3.1
Average	2.1	3.6	2.8
Lowest	2.0	2.4	2.3

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

While many still view inflation as a dead issue (citing a number of factors such as capacity utilisation, relatively high levels of unemployment (by recent historical standards), modest wage growth and retail sales etc) the potential for one-off inflationary pressures to impact on generalised inflation over the medium term should not be discounted.

First, as the economy picks up relatively strongly and capacity utilisation increases, as is increasingly evident, pressure on resources will increase with an inevitable effect on prices.

Second, inflation, as measured by the CPI is forecast in the recent budget to hit 5.9 percent to 2011 as a result of the one-offs associated with an increase in GST to 15 percent, the rise in tobacco excise taxes, the introduction of the Emission Trading Scheme (ETS) on 1 July 2010, and a rise in ACC levies for motorists in 1 July 2010.

While the Reserve Bank in terms of its mandate does not have to take into account these one-offs when setting monetary policy, the danger is that individuals and businesses will react to them.

Mainly for historical reasons, a number of businesses and indeed individuals use the CPI as a benchmark for trying to determine a number of outcomes e.g. price increases, contracts or wage rises. Quite what the CPI should have to do with trying to set contract prices in an individual market is anyone's guess, the fact remains that rightly or wrongly, the headline CPI is used as a key tool for a wide range of contract setting. The danger with a high headline CPI, is that this will be reflected in the generalised pricing decisions and thinking of both businesses and individuals, potentially impacting on generalised inflation, to which the Reserve Bank will have to respond. While not trying to create undue concern, the budget projections of inflation outcomes in the out years appear to be far too modest to say the least. Time will tell.

Third, increased disposable income as a result of the recently announced tax cuts and greater employment growth which will cut the number those dependent on welfare benefits, could provide greater spending options and generalised pressure on prices. On the other hand, the potential for a significant rise in debt servicing costs could erode away any increases in disposable income. Moreover, a perverse result of the decision to remove depreciation on buildings which are projected to last over 50 years might well be landlords trying to increase rents since they can no longer write-off this cost of housing provision.

Finally, house prices are likely to rise further as a result of still healthy net migration inflows and the time-lag between increases in building consents (which are now increasingly evident) and new houses actually coming on stream.

All of the above would suggest that, on balance, inflation is again likely to press the upper limits of the Reserve Bank's target range for inflation (1-3 percent).

1.3 Business and Consumer Confidence – riding high

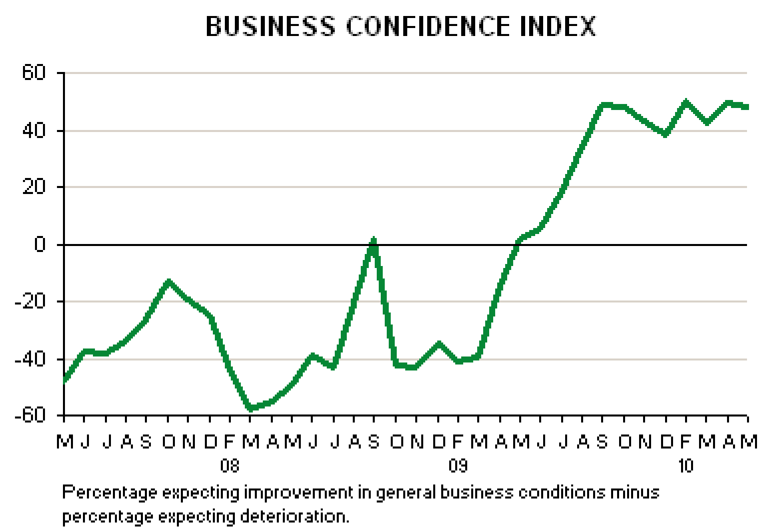
Business confidence – continues to remain high

Both business and consumer confidence have consolidated at relatively high levels. The budget announcements, in general, were well received by the business community which is likely to ensure confidence is maintained.

The National Bank's Business Outlook (May 2010) shows that confidence continues to remain high with a net 48 percent of respondents expecting better times ahead. Again, the more crucial element is firms own expectations which have recorded further improvements over recent months.

A net 45 percent of respondents expect better times ahead for their own business, the highest level recorded since May 1999. Importantly, the strength is generally across all sectors, although agriculture has taken a bit of a hit of late on the back of earlier drought conditions in certain parts of the country.

National Bank Business Confidence Index



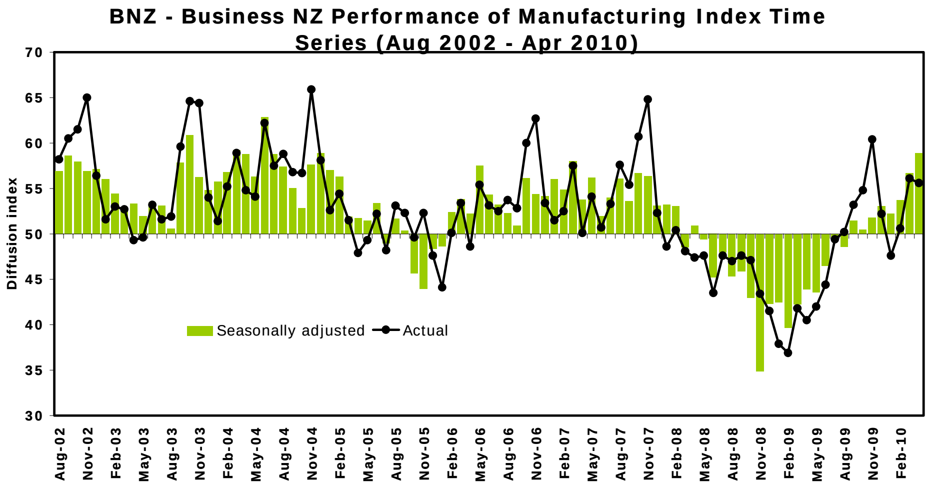
Key survey results include:

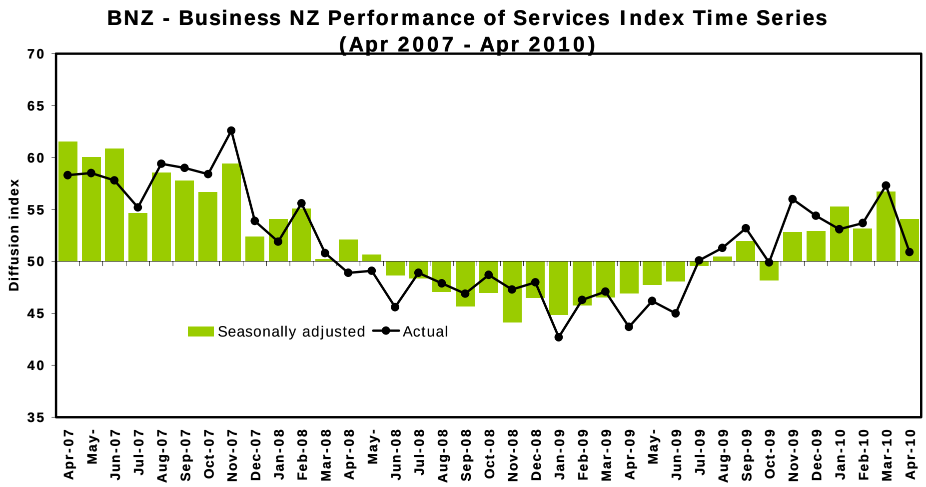
- A net 24 percent expect higher profits over the year ahead
- A net 16 percent expect to be hiring staff over the year ahead
- A net 14 percent expect to invest more (reflecting an improving trend)
- A net 33 percent expect stronger export volumes over the year ahead.

The only real fly in the ointment is the projection for inflation. While only up very marginally, inflation expectations continue to rise with pricing intentions also nudging upwards. While still under control, the inflationary trend is of some concern with more pressure likely, as outlined earlier.

Given that the close off date for responses to the survey was 14 May 2010, before the budget of 20 May, it is likely that, if anything, the budget overall should have boosted business and consumer confidence further, notwithstanding that some sectors may be unhappy with certain budget announcements e.g. changes to depreciation regimes on buildings and the removal for the 20% loading for new equipment.

Improved business confidence is reflected in the relatively strong growth in manufacturing and to a lesser extent in the services sector (which remains mixed to some extent). The latest BNZ-Business NZ Performance of Manufacturing (PMI) and Services (PSI) Indexes show continued solid, if not spectacular, improvements. The PMI stood at 58.9 for the month of April 2010, the highest since 2004 while the PSI stood at 54.1 which is close to its long-run average. While all five seasonally adjusted main diffusion indices remain in expansion (production, new orders, employment, finished stock and deliveries), the key forward looking indicators, such as production and new orders, are now reading over 60, which augurs well for future employment growth in both these major sectors.





Consumer confidence – generally positive

Consumer confidence remains strongly in positive territory as measured by a number of surveys.

The budget should mean added disposable income for most people and will assist in holding consumer confidence up, while a rapidly improving labour market will provide greater opportunity for those currently out of work to boost household incomes.

Despite significant improvements in consumer confidence over the last year, there are still some pockets of concern.

First, in a number of sectors e.g. housing and retail and data on electronic transactions have generally only improved slowly. Despite reported levels of confidence holding up reasonably well, consumers are still taking a relatively cautious approach to major expenditure decisions which is being reflected in heavy discounting by retailers to try and move stock.

Second, the potential for higher costs alluded to earlier, could act to stiffen consumption while the effects on disposable income of higher debt servicing costs have yet to hit home – given NZ's still relatively high debt burdens. The days of very low interest rates are fast coming to an end.

1.4 Labour markets – improving rapidly

Employment – moderate growth forecast with unemployment continuing to drift down

The December quarter 2009 Household Labour Force Survey (HLFS) gave what appeared on the surface an overly pessimistic view of the labour market, particularly when simply looking at the headline unemployment rate of 7.1 percent. As BusinessNZ previously pointed out, the unemployment did rise substantially, but this was largely as a result of more and more people entering the labour market as labour market conditions deteriorated and household budgets come under increased pressure. In this respect the 7.1 percent tended to disguise the fact that employment was more or less unchanged for the quarter.

The March quarter 2010 showed a quite dramatic reversal with the unemployment rate diving to 6 percent and relatively strong employment growth.

While some caution is necessary when making simple comparisons quarter by quarter, the results for the March quarter reflect a particularly strong upswing in labour market conditions with forecasts to 2012 showing unemployment is expected to continue to drift lower.

Forecasts: Unemployment % (HLFS)

	Quarter		
	June 10	June 11	June 12
Highest	7.5	6.2	5.9
Average	6.8	6.1	5.5
Lowest	6.4	5.9	5.2

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

Not only are official figures showing declines in unemployment but a number of business confidence surveys show an upswing in both business investment and hiring intentions, while the latest National Bank: Business Outlook – April 2010, indicates that a net 11 percent of respondents expect the unemployment rate to fall one year from now, up from a net 4 percent last month expecting a fall.

While employment growth per se is an important indicator of the strength of the recovery, the more important measure is the degree of growth in full-time as opposed to part-time employment. Here the results are quite staggering with effectively the entire increase in employment (over 20,000 jobs or 1 percent of those in employment) being full-time positions. Again, consistent with other surveys, employment growth has largely been across the board.

The BNZ-BusinessNZ PMI (May 2010) indicates that employment activity (52.2), has continued to steadily improve from the very negative results experienced at the same time in 2009. The BNZ-BusinessNZ PSI (May 2010) continued its upward journey to sit at 54.3 compared to 45.6 at the same time last year.

The Department of Labour's Job Ad Series shows that both the number of internet job ads and newspaper job ad numbers bottomed out in the June quarter of 2009 and have exhibited steady, but not spectacular, rises since that time. However, these improvements need to be put in perspective in that current job ads are still well below those achieved during the peak of mid-2007. Nevertheless, improvements in job ads are a clear leading indicator of potential future employment growth for the remainder of this year and beyond.

Labour costs – projected to increase modestly

Wage and salary rises have continued to trend down over the last two years given the general easing in labour market pressures. However, it is likely that some pressure will start to build reflecting the strong employment growth and the significant reduction in unemployment recorded over the March quarter 2010.

The latest official figures available show that salary and wage rates (including overtime) as recorded by the Labour Cost Index (LCI) increased by 1.5 percent from the March 2009 quarter to the March 2010 quarter. The latest annual increase is the lowest since an identical increase in the year to the September 2000 quarter. In comparison, the Quarterly Employment Survey (QES) shows that average total hourly earnings increased 2.1 percent in the year to the March 2010 quarter.

Source: Statistics NZ

Forecasts below indicate that total labour cost inflation is expected to increase modestly to around 2.4 percent by 2012. This is very much in line with the long-run average for the LCI.

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

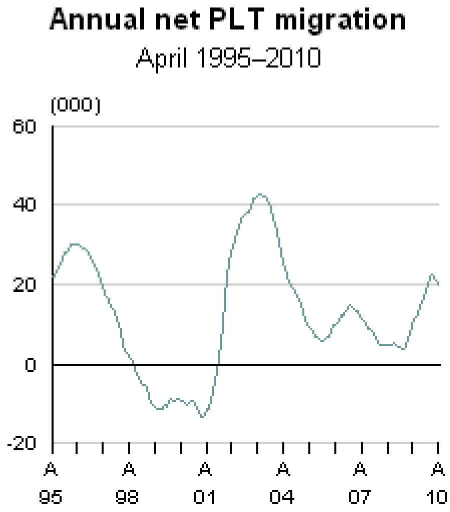
	Years ending		
	June 10	June 11	June 12
Highest	1.9	2.5	2.7
Average	1.7	2.1	2.4
Lowest	1.5	1.5	1.9

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

Net migration gains – still remain relatively high

Net permanent and long-term (PLT) migration was 20,000 in the April 2010 year, compared with 9,200 in the April 2009 year. Annual net migration has decreased from a high of 22,600 in the January 2010 year.

The net PLT gain of 20,000 in the April 2010 year was higher than the annual average of 11,900 for the December year 1990-2009. However, a large reason for the net gain in PLT over the year has been the fewer departures, particularly to Australia.



Source: Statistics New Zealand

The net PLT outflow to Australia was 14,800 in the April 2010 year, well down from 32,000 in the April 2009 year. In other words, the net PLT gain is almost entirely due to reductions in the number of departures to Australia. Given the projected upswing in the NZ economy, it is possible that this situation may continue over coming months although with a booming Australian economy it is more likely that New Zealanders will continue to be sucked across the Tasman in search of greater opportunities and higher real wages. The latest tax cuts announced in the NZ Budget are unlikely to stem this ongoing flow over the short to medium term.