Business|NZ

# Business Planning Forecasts

*23 February 2004*

## FORECASTS: MARCH QUARTER 2004

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### Introduction

This bulletin is designed to help plan your business. It brings together forecasts of important indicators to help you prepare budgets and business plans.

The forecasts are drawn from two main sources. The New Zealand information is based on a survey of the five main trading banks (ANZ, ASB, BNZ, National, and Westpac). The Australian information is based on consensus forecasts put together by the UK based magazine "The Economist". Sources of other information are as shown.

**We stress that the information in this publication is by its nature uncertain. Your firm is unique, and you will need to make your own decisions. However, we believe the better informed you are about the way various business people see the future, the better decisions you can make.**

Where appropriate we have not only included the average value across all forecasters, but also the highest and the lowest forecast. This gives some idea of the spread of forecasts, and therefore an idea of the uncertainty involved.

Business New Zealand
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# Part 1: The New Zealand Economy

## 1.1. Economic Growth (GDP)

*Most recent outcome: +3.9% for the year-ended September 2003.*

Gross Domestic Product (GDP) is a measure of total economic activity for a country over a given period. GDP growth has averaged 3.8% per annum over the past five year, with only one quarter of decline out of the last 20 (June 2000).

The June 2003 quarter saw a marked slow down in GDP growth, mainly due to a series of one-off shocks such as SARS, electricity shortages, and the Iraq conflict. However, it was also the third consecutive quarter where growth slowed, so many considered it likely that the economy was beginning to slow on a more sustained basis. However, the September quarter outcome, while expected to involve an element of 'bounce-back', increased by 1.5%, much more than anyone expected. This was due mainly to a large increase in internal demand (particularly on housing), while exports fell (reflecting the two-speed economy).

Short-term forecasts for economic growth suggest that GDP will increase by 3.3% for the year ended March 2004, but growth rates will fall to 2.8% and 2.5% for the years ended March 2005 and 2006 respectively.

**Forecasts: Real GDP % Growth**

| | Years Ending | | |
|---|---|---|---|
| | *Mar 04* | *Mar 05* | *Mar 06* |
| Highest | 3.4 | 3.2 | 2.9 |
| Average | 3.3 | 2.8 | 2.5 |
| Lowest | 3.2 | 2.5 | 2.0 |

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

Key factors to influence GDP over the next two years will include:

G*lobal economic recovery…*

The economic health of trading partners is very important not only for determining demand for New Zealand exports but also affects tourism and migration flows, so impacting on the domestic economy. The international outlook is continuing to improve, although it is feared that 'bird flu' in Asia could have the potential to be this year's SARS. Encouragingly, towards the end of 2003 we began to see an increase in the volumes of exports (and tourist numbers), although the impact on export values has been masked to date by the appreciating currency.

*Interest rates*

The prime objective of monetary policy is to achieve price stability, although its operation can have short-term implications for economic growth through changes in interest rates. On 29 January the Reserve Bank increased its Official Cash Rate (OCR) to 5.25%, a move sparked by concern about inflationary pressures arising from the strong domestic economy (particularly housing) outweighing the impact of an appreciating currency on import prices. While most economists had expected the Reserve Bank to begin tightening monetary policy in the first half of the year, moving in January came as a surprise.

*The Dollar*

The value of the New Zealand Dollar (NZD) has appreciated in value against most currencies over the past two years, although its rise has been particularly rapid against a US Dollar (USD) that has been weakening against almost all currencies. Significantly for manufacturers, the NZD fell against the Australian Dollar (AUD) in 2003 – although it has since made up some of the lost ground. Most economists expect the NZD to remain strong well into 2004 before falling against most currencies over the following two years.

*Tourism and net migration flows*

Strong tourism numbers have helped maintain robust retail sales growth, and large migration inflows have boosted domestic consumer spending, car sales and house building. Migration has also, to an extent, helped mitigate some of the pressures that have built in the labour market (although a significant contributor to net migration has been a large inflow of foreign students who will not be in the labour force). While the prospects for tourism appear good, net migration is turning downwards.

In May 2003 short-term visitor arrivals fell 13% compared to May 2002 due to the impact of the Iraq War and SARS. However, visitor numbers have since recovered, with December 2003 arrivals up 12% compared to December 2002. Most Asian markets are now recovering their earlier losses, and visitor numbers from Australia, the UK and the US are growing particularly strongly. An improved global economic outlook should be good news for tourism (although a higher NZD would not be).

The annual net migration gain peaked at 42,500 for the year ended May 2003 but has since eased to a 34,900 gain for the year ended December 2003. The Government's immigration policy changes and an improved global economic outlook are resulting in a reduction in permanent and long-term arrivals and an increase in permanent and long-term departures. A significant reduction in net migration should dampen the housing market and retail spending in 2005.

*Commodity prices and farm incomes*

The New Zealand economy remains dependent on land-based industries. Higher or lower farm incomes caused by changes in commodity prices and the value of the NZD often have significant downstream impacts on the economy as a whole.

Although international commodity prices have recovered in 2003, they remain weak when expressed in NZD terms. For example, ANZ Bank's Commodity Price Index rose by 9.6% for the year ended December 2003, but when expressed in NZD terms prices were down 10.6% for the year and remained 31% below their April 2001 peak. This should have implications for the domestic economy as the negative wealth effect works its way through provincial and eventually metropolitan economies. However, it can take time for these impacts to fully work their way through the economy and the high migration inflows since 2001 have also worked to cushion the impact of lower NZD prices.

*Infrastructure constraints*

Energy shortages had a negative impact on June quarter GDP, not just directly through less electricity being produced, but also indirectly as businesses cut back on production to make savings. More worrying for the future are the longer-term impacts caused by ongoing uncertainty of supply and resulting price increases. Meanwhile, long-term under-funding of roads has caused transport infrastructure to become one of the greatest impediments to business growth, with problems being particularly evident in, but not confined to, Auckland. Although work is being done on addressing infrastructure constraints there are no easy short-term fixes.

*Business confidence*

Business confidence influences the propensity for businesses to invest in capital and employ staff, so is an important determinant for future economic growth. 2003 saw a slump in most confidence indicators mid-year but a recovery by September. Most recently there has been a further albeit smaller downturn in business confidence.

The December 2003 NZIER Quarterly Survey of Business Opinion reported solid growth during the quarter, but ‘uninspiring’ levels of business confidence. A net 2% expect general business conditions to deteriorate over the next six months, with exporters continuing to be more pessimistic than non-exporters. Despite the lack of confidence, NZIER reported considerable pressure on resources, with demand particularly high for skilled and unskilled labour. These pressures were reflected in a lift in inflation indicators and would have been a factor behind the Reserve Bank’s decision to increase the OCR.

The National Bank Business Confidence Index also recorded a downswing in confidence, with a net 16% of respondents expecting general business conditions to deteriorate over the coming 12 months.

Meanwhile, the ANZ-Business New Zealand PMI stood at 54.0 for December 2003, compared to 56.4 in December 2002. While any value over 50 indicates expansion, it would appear that manufacturing is growing more slowly than it was a year ago.

*Consumer confidence*

The Westpac McDermott Miller Consumer Confidence Index rose in the December 2003 quarter to its highest level since March 1996 (126.0). Strong employment growth, lower interest rates and higher house prices have made homeowners feel wealthier, underpinning strong growth in retail sales (up 4% for the year ended November 2003). Consumer confidence levels are likely to remain at healthy levels well into 2004, which should continue to maintain robust growth in retail sales, all other things being equal.

## 1.2 Inflation

*Most recent outcome: +1.6% year-ended December 2003*

The rate of inflation, as measured by the Consumer Price Index (CPI), provides an indication of the extent to which price levels have increased and a benchmark for wage demands.

The booming housing market has been cited as one of the main inflation drivers over the past two years, with the Housing group of the CPI increasing by 6.6% for the year ended December 2003. However, government policy changes can also have a major impact on the CPI, with Central and Local Government Charges increasing by 6.3% over the same period. Much of this increase was driven by higher local authority rates and higher excise taxes for petrol, alcohol, and tobacco.

Inflation fell sharply from 2.5% for the year ended March 2003 to 1.5% for the year ended June 2003 and has remained at around 1.5% since, although the December quarter outcome (0.7%) was significantly higher than anyone had expected.

The higher NZD has acted as a dampener on 'tradeable' inflation, which remains negative, but 'non-tradeable' inflation remains persistently above the Reserve Bank's level of comfort. High non-tradeable inflation largely reflects strength in the housing sector and the impact of central and local government charges. These influences explain Reserve Bank Governor's public comments seeking to talk down the boom in house prices[1] and his public castigation last year of local authorities for their large rates increases.

Overall, the CPI is forecast to remain well inside the Reserve Bank's 1-3% target in the short-term, although forecasts have been revised upwards since the last quarter. However, the Reserve Bank Governor must take a medium-term approach to the conduct of monetary policy and in the medium-term, the annual increase in the CPI is expected to increase closer to the target ceiling.

**Forecasts: % Change in Inflation (CPI)**

| | **Years Ending** | | |
|---|---|---|---|
| | *Mar 04* | *Mar 05* | *Mar 06* |
| Highest | 1.8 | 2.8 | 2.6 |
| Average | 1.7 | 2.3 | 2.3 |
| Lowest | 1.7 | 1.9 | 2.1 |

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

[1] Although house prices are not included in the CPI, the housing boom has flow on impacts for rents and prices for house construction. The Reserve Bank is also taking interest in the housing boom for the simple reason that asset price bubbles tend to burst – even house prices have experienced lengthy periods where prices have fallen in real if not nominal terms following booms.

### 1.3 Labour Costs

*Most recent outcome: +2.4% year-ended December 2003*

Statistics NZ produces an index that measures movements in the total cost of employing labour, the Labour Cost Index (LCI). The LCI has fixed industry and occupation weights and measures changes in wages and salaries for a fixed quantity and quality of labour input. As such, the LCI is preferred by the Reserve Bank as a measure of labour costs.

Growth in the LCI has increased steadily over recent times, with the increase to the year ended December 2003 being the highest annual increase since September 1997. Stronger demand for labour has caused skills shortages in a number of industries and regions, so pushing up average labour costs. Stronger net migration has tended to mitigate some of the pressure, but only to a degree as a significant proportion of migrants have been students and therefore not in the labour force.

While real wages (as measured by the LCI) fell during 2000-02, they have recovered with the slowing in the rate of increase in the CPI over the past year. Forecasts though suggest that this recovery will only be short-lived, with growth in the LCI once again falling below that of the CPI by 2005.

**Forecasts: Labour Cost Index % Change**

| | **Years Ending** | | |
|---|---|---|---|
| | *Mar 04* | *Mar 05* | *Mar 06* |
| Highest | 2.6 | 2.3 | 2.1 |
| Average | 2.4 | 2.1 | 2.0 |
| Lowest | 2.1 | 1.9 | 2.0 |

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

An alternative measure of labour costs is the Quarterly Employment Survey (QES). The QES tends to be much more volatile than the LCI, mainly because it not only measures changes in pay rates, but it also measures compositional changes in the labour force. The most recent QES release shows that average hourly earnings grew by 3.3% for the year-ended December 2003, down from a 3.7% increase for the year-ended May 2003.

Both the QES and the LCI have recorded significantly larger increases in labour costs for the public sector as opposed to the private sector. As measured by the QES public sector hourly earnings are 33% higher than those in the private sector, with the gap having widened over the past two years.

## 1.4 Employment

*Most recent outcome: +2.7% year-ended December 2003*

Employment growth has been strong for the past four years, with the number employed growing by 12% and the unemployment rate falling from 6.6% to 4.6%.

The December 2003 quarter saw a reduced rate of employment growth (0.1% for the quarter) and a rise in unemployment from 4.4% to 4.6%. Despite this softer data, economists continue to consider that the labour market remains tight, although most are predicting an increase in unemployment over the next two years as the economy slows.

In the year to December 2003, 51,000 more people were employed. With the working age population increasing by 62,000 over the same period (due in large part to strong net migration gains), the labour force participation rate increased from 66.3% to 66.5%, another indication of a tight labour market.

Encouraging, the substantial fall in unemployment over recent years has been broadly based across the sexes, ethnic groups, and regions. However, the composition of employment growth since June 2001 very much reflects the strength of the domestic economy and weakness of export-oriented sectors since that time.

There have been strong gains for construction, wholesale and retail trade, education, and health and community services, but employment levels have been static or have fallen in agriculture, forestry, and fishing, manufacturing, transport, storage and communication, and business and financial services. The manufacturing sector is still the largest employer but its employment is down 9,500 on June 2001 and manufacturing now makes up 14.2% of people employed compared to 15.9% in June 2001.

Although employment growth appears to be easing, it should continue to sustain the domestic economy through consumer spending and residential construction.

**Forecasts: Unemployment % (HLFS)**

| | **Years Ending** | | |
|---|---|---|---|
| | *Mar 04* | *Mar 05* | *Mar 06* |
| Highest | 4.6 | 5.1 | 5.5 |
| Average | 4.5 | 4.8 | 4.9 |
| Lowest | 4.2 | 4.4 | 4.1 |

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

## 1.5 Interest Rates (90-day bill rate)

*Most recent outcome: 5.59% as at 20 February 2004*

In general, overdraft and mortgage interest rates move in line with the 90-day bill rate, which is in turn heavily influenced by the Reserve Bank's OCR.

During the middle of last year the Reserve Bank cut the OCR by 0.25% three times to reach 5% by August. This easing had followed comments in January 2003 by the Reserve Bank Governor that there would be scope for interest rate cuts if the NZD maintained its strength and inflationary pressures eased. Both conditions were met.

During the second half of the year it became apparent that the domestic economy was stronger than previously thought. As a result the mood on future direction of the OCR shifted significantly, with the debate turning to the timing for its first increase, rather than whether there should be an increase.

Prior to the Reserve Bank's surprise increase in the OCR on 29 January most commentators had expected it to hold off until at least March before acting, with the view being that the strong NZD was already acting to constraint imported inflation and that its quick appreciation had hurt many exporters. However, a series of strong data releases (including GDP and CPI inflation) in December and January clearly pushed the Reserve Bank into acting sooner.

Most forecasters are suggesting that by March 2004 90-day bill rates will have increased to around 5.7% and 5.8% by this time next year. This implies a moderate further tightening by the Reserve Bank, but nowhere near as dramatic as the increase in the OCR from 4.5% to 6.5% between November 1999 and May 2000.

**Forecasts: Interest Rates (90 day bills)**

| | As at End of | | |
|---|---|---|---|
| | *Mar 04* | *Mar 05* | *Mar 06* |
| Highest | 5.9 | 6.2 | 6.1 |
| Average | 5.7 | 5.8 | 5.7 |
| Lowest | 5.6 | 5.6 | 5.2 |

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

## 1.6 Exchange Rates

*Most recent outcome: NZD = USD0.7027 as at 20 February 2004*
*NZD = AUD0.8867 as at 20 February 2004*
*TWI = 68.8 as at 20 February 2004*

In 2003 the NZD has appreciated by 24% against the USD, 12% against the Pound, 12% against the Yen, 4% against the Euro, but fell 6% against the AUD. Overall, the Trade Weighted Index (TWI) increased by 11% during 2003. Since the start this year the NZD has made further gains against all currencies, including the AUD. The strengthening of the NZD has caused considerable concern to many exporters.

Comparative interest rates are just one of a number of factors that can influence exchange rates. Others include current account deficits and relative growth rates. With New Zealand's growth rates being higher than most OECD countries over the past few years it is perhaps not surprising that the NZD has increased in value. There is little that can be done to directly influence an exchange rate, as the Minister of Finance has recently acknowledged.

All economists agree that accurately forecasting changes in exchange rates is fraught with difficulty – currency forecasts must be treated with caution. However, the USD is expected to continue weakening against all currencies due to its large current account deficit. Therefore most economists still expect the NZD to rise against the USD in the short-term before falling back again over the next two years as New Zealand's growing current account deficit causes a readjustment in the NZD.

Although the NZD has risen against the AUD by 1.5% since the start of the year, it is forecast to fall against the AUD over the next two years. Australia is New Zealand's largest trading partner and by far New Zealand's largest market for manufactured products, so depreciation should help soften the blow for some exporters.

Overall, the TWI is expected to fall over the next two years, so increasing export prices when expressed in NZD terms. Higher rates of trading partner growth in 2004 should also help increase demand and therefore export volumes.

| **AUD (cents)** | | | |
|---|---|---|---|
| | *Mar 04* | *Mar 05* | *Mar 06* |
| Highest | 88.2 | 86.5 | 85.7 |
| Average | 87.6 | 84.2 | 83.0 |
| Lowest | 87.3 | 83.0 | 80.6 |

| **USD (cents)** | | | |
|---|---|---|---|
| | *Mar 04* | *Mar 05* | *Mar 06* |
| Highest | 69.5 | 65.0 | 59.1 |
| Average | 68.2 | 64.2 | 56.9 |
| Lowest | 67.0 | 63.1 | 55.4 |

| **TWI** | | | |
|---|---|---|---|
| | *Mar 04* | *Mar 05* | *Mar 06* |
| Highest | 67.6 | 64.4 | 59.8 |
| Average | 67.1 | 62.5 | 58.2 |
| Lowest | 66.4 | 61.1 | 56.9 |

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

In practice, buying forward foreign currencies can reduce the risk in cross rate movements. Forward cover rates are based on the exchange rate when it is bought, so it pays to watch daily movements and buy at the right time, particularly in light of recent movement in the exchange rate with Australia and the United States. Forward cover rates can be obtained from banks.

# Part 2: The Australian Economy

Monitoring the performance of the Australian economy is critical in that firstly, it provides a measure of how well New Zealand exporters are likely to fare (a stronger Australian economy will be generally 'suck in' imports) and secondly, it provides an indication of the likely strength of competition from Australian sourced products on the domestic market.

## 2.1 Economic Growth (GDP)

*Most recent outcome: +2.5% for the year-ended September 2003.*

Forecasts:
- December 2003: +2.8%
- December 2004: +3.7%

Source: The Economist

As was the case for New Zealand, Australian GDP bounced back from a low June quarter outcome, annual growth recovering from 2.0% to 2.5%. Despite concerns about the impact of a high AUD on export competitiveness, forecasts continue to suggest that GDP growth for the December 2003 year will recover to 2.8% and accelerate further to a robust 3.7% in 2004.

The latest Australian PMI results shows manufacturing activity remaining solid with a reading of 56.8 for January 2004, up slightly on December. Again, as with the case in New Zealand, a solid domestic economy is underpinning activity, with retail sales volumes up 7.3% for the year ended December 2003.

## 2.2 Headline Inflation

*Most recent outcome: +2.4% for the year-ended December 2003*

Forecasts:
- December 2003: 2.7%
- December 2004: 2.2%

Source: The Economist

After breaching the higher limit of the Reserve Bank of Australia's 2-3% target in March 2003, inflation has steadily eased as the economy has slowed and the appreciation in the AUD (particularly against the USD) has taken effect.

Australia's wage cost index increased by 3.6% for the year ended September 2003, but at a rate of 5.6% unemployment remains considerably higher than New Zealand's current rate of 4.4%.

## 2.3 Interest rates (90-day bills)

*Most recent outcome: 5.56% as at 20 February 2004*

Forecasts:

- March 2004: 5.55%
- September 2004: 5.90%

Source: HSBC

In November and December the Reserve Bank of Australia (RBA) increased its OCR twice, from 4.75% to 5.25%. With New Zealand's OCR also at 5.25%, 90-day bill rates in the two countries are now almost identical.

The financial markets have priced in further increases in Australian interest rates. Like the RBNZ, the RBA is worried about the impacts of rapid house price inflation and will be concerned if Australian fiscal policy becomes overly expansionary in 2004 (an election year).

## Part 3: Rest of the World

The economic picture in the rest of the world is very important for New Zealand. Generally speaking, the international climate has not been particularly favourable over the past three years, but it now appears that a sustained recovery is underway.

*United States*

The impact of expansionary monetary and fiscal policy over recent years is being felt with GDP growth forecasts upgraded to a robust 4.6% for 2004. This improvement has been sparked by recent positive data on GDP, industrial production, and retail sales coupled with strong levels of consumer and homebuilder confidence. Business confidence has also been improving over recent months, with the ISM manufacturing index (the US version of the PMI) currently at its highest point since December 1983.

Although the Federal Reserve has maintained its Federal Funds Rate at 1%, recent economic developments have resulted in a subtle change in the Fed's language, indicating that it is getting closer to tightening monetary policy. However, with the US trade deficit rising by 17% during 2003 (to be at an all time high), it seems likely that the USD will continue to weaken in 2004.

*Japan*

For the past decade the Japanese economy has been stagnating and suffering from prolonged deflation. However, there have more recently been signs of a rebound, with strong data on industrial production and GDP. Forecasters have upgraded their GDP forecasts for Japan, with growth is expected to be around 2.3% for 2003 and 2.1% for 2004 – modest but significantly better than recent years' outcomes and earlier forecasts. The situation is still patchy, however, and economic reform is still desperately needed (but is still being resisted).

*Asia*

Asian economies were hit hard by the impact of SARS last year, but most have since bounced back. Despite SARS, China's GDP growth is still forecast to have been around 10% for 2003, while India's GDP grew by 8.4% and Thailand's by 6.5%. Singapore, Hong Kong, Malaysia, and Taiwan are also growing at around 4% per annum after slumps in 2002/03. Although this is good news for New Zealand exporters, the impact of the 'bird flu' is a great unknown for 2004.

*Europe*

GDP growth in the Euro area is currently registering at just 0.6% but is likely to improve slightly to 1.9% for 2004. France and Germany are particularly weak due to their inflexible economies. Ironically, the European Central Bank's relatively tight monetary policy is working against Germany, the very country that insisted on initiatives like the fiscal stability pact. Non-Euro countries with the freedom to set their own monetary policy, such as the United Kingdom and Sweden, have fared somewhat better (although Switzerland has not).

*World Outlook*

Most economists are predicting that 2004 should be a better year. An improved global outlook would obviously be good news for New Zealand, but unexpected events (e.g., SARS, war, terrorist attacks etc) show how fragile economies can be.

***Forecasts: World GDP Growth (Selected Trading Partners)***

| *Country* | *2003* | *2004* |
|---|---|---|
| Australia | 2.8% | 3.7% |
| Canada | 1.7% | 3.1% |
| Japan | 2.3% | 2.1% |
| United Kingdom | 2.1% | 2.8% |
| United States | 3.2% | 4.6% |
| Euro Area | 0.5% | 1.9% |

Source: Economist

Global inflation is expected to ease slightly in 2004, but remain at moderate levels, as economies begin to recover (there is likely to a fair bit of unused capacity which will allow for non-inflationary growth in many countries).

***Forecasts: World Consumer Price Inflation (Selected Trading Partners)***

| *Country* | *2003* | *2004* |
|---|---|---|
| Australia | 2.7% | 2.2% |
| Canada | 2.7% | 1.6% |
| Japan | -0.3% | -0.2% |
| United Kingdom | 1.4% | 1.5% |
| United States | 2.3% | 1.5% |
| Euro Area | 2.0% | 1.7% |

Source: Economist