BUSINESS NZ

PLANNING FORECAST

BusinessNZ

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Onward and upward after short-sharp recession

Executive summary

Economy

Despite significant pockets of doom and gloom, there are signs the economy has bottomed out after a rather short, sharp recession and an export-led recovery is on the cards later this year.

Growth is expected to pick up towards the end of 2008 and into 2009 with a number of positive factors likely to impact on output at that time. These include the combined effects of personal income tax cuts from October 1 2008, recovery in agricultural production from the drought of 2007/08 and added expansion in the dairy sector as a result of significant conversions. Commodity prices remain at historically high levels, despite some projections these will ease over the near term as the global economy slows. Also, the continuing slide in the NZ dollar and expectations of further, perhaps significant, cuts in the OCR by the Reserve Bank should flow through into reduced debt servicing costs for both businesses and households.

Despite the above, significant negative factors remain. The housing market remains in the doldrums with the potential for significant price cuts while the big issue is the future direction of inflation. While international oil prices have dropped around 20 per cent over the last month, from $US147 per barrel to around $115, the future direction is largely uncertain. A sliding dollar will boost returns to some exporters but is likely to compound inflationary pressures and to impact adversely on inflationary expectations in terms of business pricing decisions and employee wage claims.

Business and consumer confidence continue to languish after falling out of bed earlier this year. While business and consumer confidence surveys need careful interpretation, the severity of businesses' own pessimism and activity levels are still a cause for concern. Consumer confidence has also taken a plunge, although this may be driven by increasing food and fuel prices, while the decline in the housing market has generally resulted in more gloomy consumers with associated impacts on discretionary spending (e.g. retail sales and consumer durables). Upcoming tax cuts and reduced pressure on fuel prices should see consumer confidence rebound in the spring although this may be tempered by a lull in labour market activity, with projections of further rises in unemployment over the next year.

HIGHLIGHTS

Growth is expected to pick up towards the end of this year, underpinned by an export-led recovery. However, domestic activity is likely to remain subdued for some time.

World commodity prices remain at historically high levels, and with the NZ dollar declining, expectations are for significantly improved returns for New Zealand exporters.

Further falls in both the NZ dollar and interest rates are expected over the next year, although falls in the OCR won't automatically flow through to reduced interest rates for businesses and households.

Inflationary pressures remain, despite a significant easing in oil prices recently.

An increase in the number of people seeking employment at a time when labour market conditions are deteriorating will see unemployment bounce up over the next few quarters. However, wage demands may take some while to ease back given traditional time lags.

Part 1: The New Zealand Economy

1.1. Economic growth (GDP) – currently negative but positive outlook

Most recent outcome: 3 per cent for the year to March 2008

Gross Domestic Product (GDP) is a measure of a country's total economic activity over a given period. Since 2000, New Zealand's annual GDP growth has averaged more than 3 per cent, indicating a relatively strongly performing economy with higher growth than many other developed countries. However, growth has taken a hit on the back of a slowing international economy, with expectations for growth dropping in 2008/09, as indicated below, before recovering in 2009/2010.

Growth for the March quarter 2008 decreased by 0.3 per cent, following an increase of 0.8 per cent in the December 2007 quarter.

While awaiting official confirmation of the growth rate for the June quarter, it can be taken as given that economic growth will be negative, and possibly for the September quarter as well.

As expected, agricultural production took a significant hit for the March quarter with activity in primary industries decreasing 4.1 per cent, while goods producing industries declined 1.9 per cent. Stock were sent to slaughter earlier (including some capital stock) as a result of the drought at the end of 2007, perhaps artificially inflating growth for the December quarter 2007. Milk production also took a hit, as reflected in recent export volumes but this was more than compensated for by higher intentional commodity prices, resulting in continued improvements to New Zealand's terms of trade.

Growth is expected to pick up towards the end of 2008 and into 2009 as a result of a number of positives which are likely to impact on output at that time. These include the combined effects of personal income tax cuts from October 1, recovery in agricultural production from the drought of 2007/08 and added expansion in the dairy sector as a result of significant conversions, continued high export prices both in real terms and as a result of the continuing slide in the NZ dollar and finally, expectations of further, perhaps significant, cuts by the Reserve Bank in the OCR.

Forecasts: Real GDP % Growth

	Years Ending		
	Sep 08	Sep 09	Sep 10
Highest	1.5	1.9	3.7
Average	1.5	0.8	3.0
Lowest	1.4	0.2	2.2

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

Business NZ believes key factors influencing GDP over the next two years will include:

Interest rates – down but don't expect a dive

The Reserve Bank lowered the OCR from 8.25 per cent to 8.0 per cent at the last review. While it was a 50:50 call whether the Governor would lower the OCR, it was generally acknowledged that while the domestic economy had slowed faster than expected, the main emphasis of the cut was on mitigating the rising costs of capital on international markets i.e. to effectively stop interest rates from rising even higher.

The Reserve Bank stated in its review of the OCR that provided the outlook for inflation continues to improve and there is no excessive exchange rate depreciation, it can be expected to lower the OCR further.

Hindsight is a wonderful thing, with some commentators (rightly in our view) previously concerned the Reserve Bank had moved too early to reduce rates, given still significant inflationary pressures in the economy. But a month has proven to be a long time in the life of oil prices, which have now dropped from record highs of around $US147 per barrel to around $114. Given the flow-on effects of international prices, the Reserve Bank, largely as a result of luck, timed its cut in the OCR very well.

Notwithstanding very short-term reductions in oil prices which should help ease built up pressures in the economy, there are a number of reasons why we believe significant further cuts in the OCR may not be on the cards, and even if they were, why they may not flow through immediately into a lower cost of capital for businesses and households.

Here are five reasons why we believe significant cuts in interest rates facing businesses and households may not happen any time soon:

1. Inflationary pressures will remain a concern for some time, boosted by rising food prices, continuing wage inflation, and the potential for upcoming tax cuts to be spent rather than saved.
2. Any sudden drop in the dollar will exacerbate imported inflationary pressures, even though many importers have taken appropriate currency hedging to mitigate such risks.
3. A significant repricing of risk in light of the international credit crunch means there is no guarantee a drop in the OCR will necessarily result in a reduction in interest rates facing businesses and households. Given New Zealand's exposure to debt, repricing of risk has resulted in a (roughly) 0.5 per cent increase in interest rates over recent months. The increase occurred though the Reserve Bank maintained the OCR at 8.25 per cent for the best part of a year and was the reason why it recently cut the OCR 0.25 percentage points. International investors build in a risk margin which banks have to pass on both to businesses and consumers.
4. Significant numbers of people are tied into fixed rate mortgages.
5. Competition in the banking sector has encouraged many banks to build in lower interest rates already.

Official Interest rates

Central Bank	Current rate (%)	Previous rate (%)
Reserve Bank of Australia	7.25%	7.00%
US Federal Reserve	2.00%	2.25%
Bank of England	5.00%	5.25%
European Central Bank	4.25%	4.00%
Reserve Bank of NZ	8.00%	8.25%

The New Zealand Dollar – finally on the slide (for real this time)

After a number of promising but ultimately false starts, it's almost universally accepted that a continued easing of the New Zealand dollar against most major currencies over 2008 is a given. However, how fast and by how much this will occur is at best difficult to establish as the recent 'blip' in exchange rate shows. The slight appreciation in the NZ dollar against the Australian of late is largely as a result of international investors moving out of strong commodity currencies (such as Australia) and back into stock currencies such as the US and Euro. The NZ dollar will not be immune from this move so expect a further trend downward over coming months.

Strong inflationary pressures have also placed upward pressure on international interest rates with a number of central banks raising rates. This means the differential between NZ and our major trading partners is not as great as previously. This should also take some of the pressure off the NZ dollar.

On a trade-weighted index (TWI) basis, the TWI has dropped from a high of around 74 cents to sit around 66 cents currently (an 11 per cent reduction) over the past five months.

While the TWI is likely to continue to bounce around over the next few months in light of changing international circumstances, the general trend is clearly downward, as forecasts clearly show (see below).

Net migration flows – bottoming out?

Over 2004-06, relatively large migration inflows, on average, boosted domestic consumer spending, car sales and house building. Migration has helped mitigate some of the pressures building up in the labour market. However, over the last year or so, net migration flows have continued to slow, although recent data would suggest that we might have reached a low point with a slight upturn expected over the next few quarters. Given that net migration is a very useful leading indicator for future economic growth prospects it would not be surprising to see net gains over the next few months. However, current figures available still look pretty dismal.

A net inflow of 39,700 non-New Zealand citizens and a net outflow of 34,800 New Zealand citizens was recorded in the year ended May 2008. The majority of the net outflow of New Zealand citizens was to Australia (31,500) followed by the United Kingdom (1,000), and the United Arab Emirates and Canada (both 400).

Perhaps of more immediate interest in respect to the impact of net migration on the labour market is that migrants aged 15-29 years accounted for 40 per cent of the net outflow to Australia in the May 2008 year, while another 23 percent were aged 30-44 years.

Net outflows to Australia were recorded in each broad occupation group, led by professionals (2,100), service and sales workers (2,000) and trades workers (1,900).

The continued reduction in the net inflow of migrants has a two-fold effect. On the positive side, it continues to take pressure off housing demand and this will be welcomed by the Reserve Bank (although a significant reduction in demand which causes house prices to collapse would not be desirable because of the flow-on effects on other asset groups, as well as on confidence to invest). On the other hand, it means less skill capacity in New Zealand and continued upward pressure on wages, given limited flexibility to provide more labour. Nevertheless, with labour market pressures easing, the adverse impact of low net migrant inflows may be less than previously envisaged, although wage pressures continue to persist despite clear evidence of underlying employment losses.

Commodity prices – still holding up

New Zealand producers continue to benefit from high international commodity prices, and with the NZ dollar on the slide, this will significantly add to returns over the next year or so.

The ANZ Commodity Price Index stood at 223.5 in July 2008 (up 1.8 per cent from the previous month) and hitting a new record high. The Index was up 8.7 per cent on the same time the previous year.

When converted into NZ dollars, the ANZ NZ Dollar Commodity Price Index surged 2.8 per cent for the month of July 2008 to 163.2, which is also a record high for the series. The strong growth over the last month was a result of both increasing export prices, together with a weakening NZ dollar which have had the combined effect of substantially raising returns to many exporters. On an annual basis commodity prices, when converted into NZ currency, were up 14.4 per cent, reflecting the impact of a generally persistent high dollar until recently.

Given that the NZ dollar is likely to drop further, perhaps significantly, then the potential exists for NZ's major exporters to reap the benefits of both high commodity prices and a declining NZ dollar. This will likely result in Fonterra revising upwards their projected payout to farmers for the 2008/09 dairy season.

	World Price Index	Monthly % Change	Annual % Change	NZ$ Index	Monthly % Change	Annual % Change
July 2003	120.0	0.7	6.9	107.5	-0.7	-11.0
July 2004	149.3	0.5	24.4	123.7	-2.4	15.1
July 2005	155.3	-0.5	4.0	121.3	3.4	-1.9
July 2006	152.3	0.5	-1.9	132.7	0.9	9.4
July 2007	205.7	4.6	35.1	142.7	1.1	7.5
July 2008	223.5	1.8	8.7	163.2	2.8	14.4

Source: ANZ Commodity Price Index NZ – 5 August 2008

Business confidence – languishing but prospects look better

Both business and consumer confidence dropped with a thud over the last quarter of 2007 and first quarter 2008 and have languished in the doldrums since. While business and consumer confidence is currently low, there are a number of factors which should reignite confidence towards the end of this year and into 2009. In terms of business, interest rates are moving down while the long-awaited decline in the exchange rate has arrived, which will take some of the pressure off exporters and boost returns. In terms of consumers, again, declines in interest rates and long-awaited personal income tax cuts will boost disposable income. Also in the background are declining international oil prices (although their future direction is uncertain), which will take some of the heat out of headline inflation.

On the other hand, there is continued nervousness around a number of finance companies and also the fact that some mortgage investment funds have been frozen as investors increasingly seek to exit "vulnerable" markets (e.g. housing mortgages). This may encourage businesses and householders to take a cautious approach to new investment and/or seek investments which provide high returns to compensate for such risks. This is at the heart of international interest rate hikes which essentially represent a repricing of risk.

According to the NZIER's Quarterly Survey of Business Opinion (QSBO – July 2008), on a seasonally-adjusted basis, a net 54 per cent of firms expect the general business situation to deteriorate over the next six months. This is more-or-less the same as the previous quarter.

On a seasonally-adjusted basis, the net balance of firms reporting a decrease in their own activity in the June quarter was 18 per cent. In the previous quarter a net 7 per cent reported a decline. To put this in context, the 18 per cent figure is the highest number of respondents reporting a decrease since June 1998.

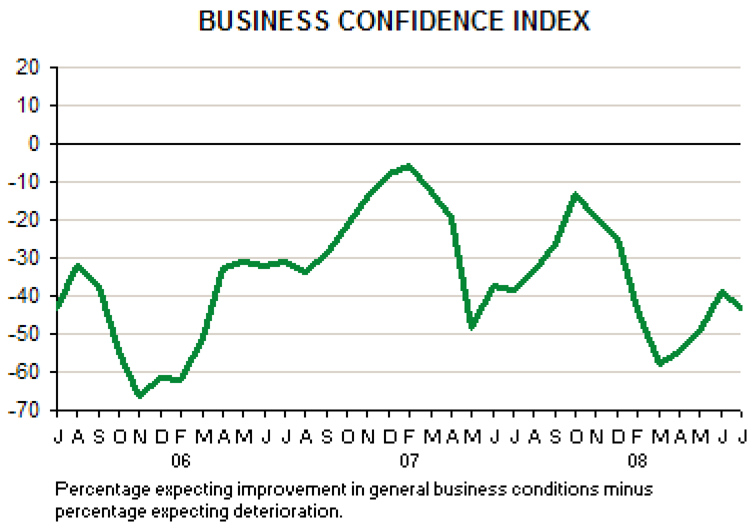
A net balance of 19 per cent of firms recorded that they expect their own trading activity to decrease in the next three months from its level in the June 2008 quarter. In the previous quarter the net balance was 8 per cent expecting a decline. This 18 per cent is the equal highest expecting a decrease since December 1982. The previous occasion the figure was 18 per cent was March 1991.

Pricing intentions and cost conditions continue to increase while a net 6 per cent of firms intend decreasing staff numbers over the next three months.

Capacity utilisation is coming off a peak, being 92.4 per cent in the June 2008 survey, a small decrease from the 92.6 per cent recorded in the March survey. However, to put these figures in context, the March figure was the equal highest rate recorded since the series began in 1961. The previous occasion the figure was 92.6 per cent was in December 2004. These figures suggest that the current doom and gloom story being painted by a number of commentators is not consistent with the wheels falling off the economy but more consistent with a hiccup on the way through.

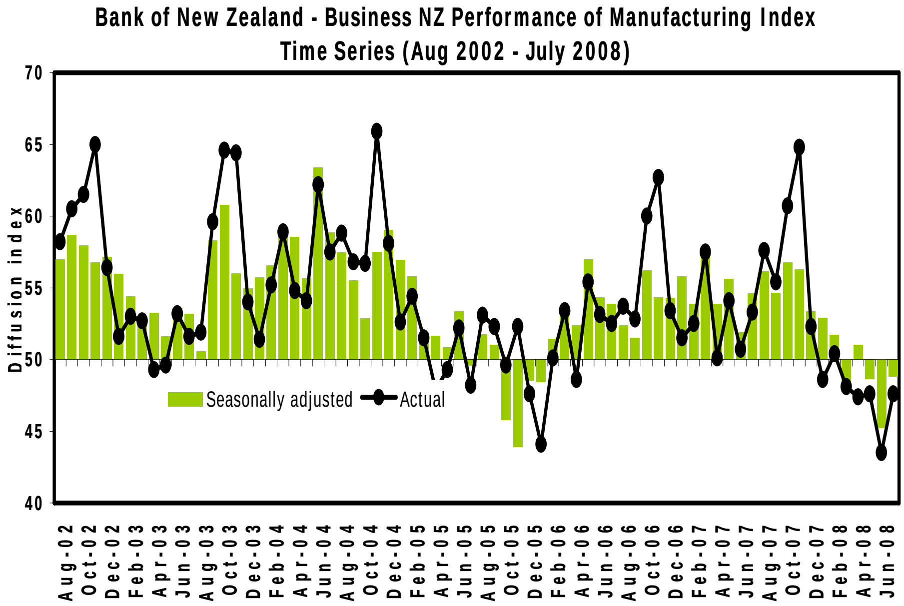
The National Bank's Business Outlook (July 2008) also shows business confidence down, with a net 43 per cent expecting worse times over the year ahead, compared with a net 38 per cent the previous month.

National Bank Business Confidence Index



Other indicators of business confidence also show that negative sentiment abounds. The Bank of NZ – Business NZ Performance of Manufacturing Index (PMI) and Performance of Services Index (PSI) both show continued declines over recent months. The PSI (for the month of July 2008) shows the index at its second lowest level (48.9) since the series began in April 2007.

The PMI provides much more useful data given the series has been going for more than five years. Again the results show a continued slowdown in activity levels with the series having been in negative territory for four of the last five months (currently 48.8 on a seasonally-adjusted basis for the month of July 2008).



Consumer confidence – way down but light at the end of the tunnel

Consumer confidence is also at low levels by historical standards but is likely to improve on the back of personal tax cuts later this year and expectations of further reductions in interest rates. Any international reductions in oil prices will also flow through into reduced fuel prices facing consumers. However, a significant decline in the exchange rate could well offset fuel price reductions.

According to the Westpac McDermott Miller Consumer Index, consumer confidence nosed-dived in the June 2008 quarter. The index fell to 81.7 in June – the third lowest in the 20-year history of the survey. Confidence has not been as low since the early 1990s. As stated above, some positives are likely to boost confidence although consumers may well batten down the hatches over the near term as the housing market takes a pounding during the next few months and expectations of further employment cuts flow through.

The big issue facing households in New Zealand continues to be rising debt levels and the ability to service that debt. While not significant, a number of mortgagee sales have been reported of late while a number of major company mortgage investment funds have been frozen, further impacting on consumer confidence.

Not surprisingly, reduced consumer confidence has flowed through into reduced domestic activity both in terms of house construction and retail sales. Building permits for dwellings continue to fall away – a trend which has intensified from mid-2007.

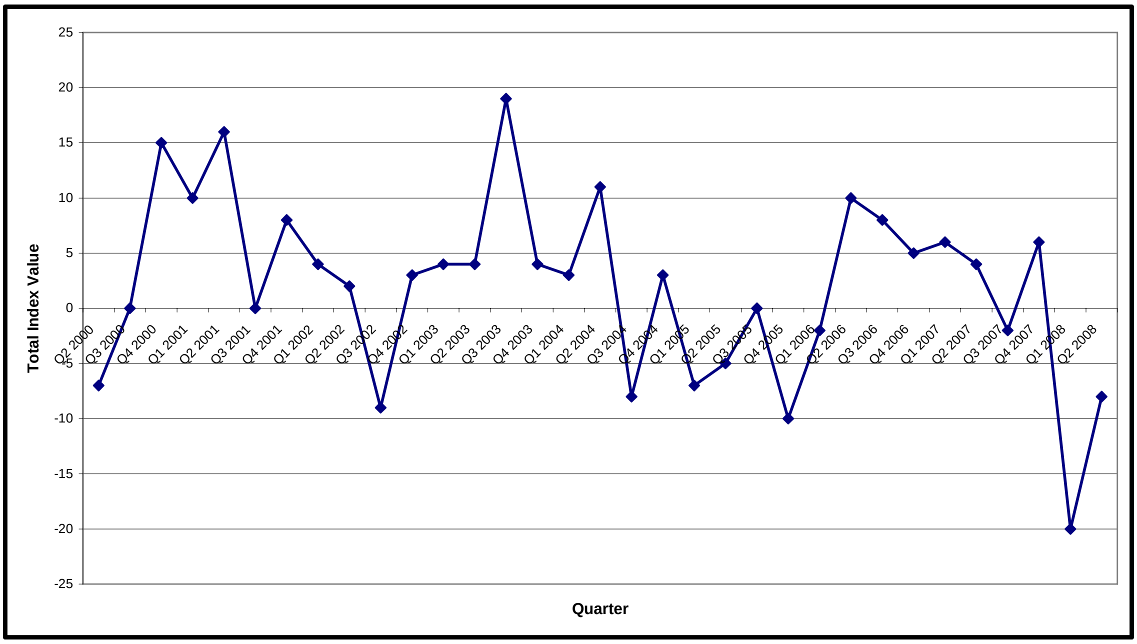
The trend for retail sales, while fluctuating on a monthly basis, is basically flat and retail volumes are falling. Sales would be down even further but until recently have been held up to some extent by rising fuel and food prices. On the other hand, motor vehicle retailing continues to take a hit as consumers pull back on discretionary spending.

Putting it all together – climbing out after dropping into a crevasse

The overall Business NZ Economic Conditions Index (a measure of the major economic indicators) sat at -8 for the June 2008 quarter, up 12 on the previous quarter but down 12 on a year ago. The March 2008 quarter recorded the lowest value (-20) since the Index began in 2000.

While the June 2008 quarter showed a significant improvement on the March quarter, this was principally because of a couple of rogue results in the March quarter (particularly employment–related data) which tended to put that quarter in a particularly bad light and the June quarter in a much better light than can be justified by the main core economic indicators.

Business NZ Economic Conditions Index



Inflation – strong pressures persist

Most recent outcome: +4.0 per cent, year-ended June 2008

The rate of inflation as measured by the Consumer Price Index (CPI) indicates increases in price levels and provides an indirect benchmark for wage demands. It is also the key reference point for monetary policy.

The June quarter 2008 CPI rose 1.6 per cent on the March quarter, bringing headline annual inflation to 4.0 per cent - again outside the Reserve Bank's target range of 1-3 per cent.

Inflation increased by 1.6 per cent for the June quarter 2008, bringing the annual rate to 4.0 per cent. The main drivers of the increase for the June quarter were in the transport, food, housing and household utilities group.

Transport prices increased 4.9 per cent, driven by higher prices for petrol.

Food prices rose 2.2 per cent, driven by higher prices for grocery food.

Housing and household utilities prices rose 1.2 per cent, with the main contribution coming from higher electricity prices.

For the year to June 2008 quarter, the tradable component rose 4.8 per cent and the non-tradable component increased 3.4 per cent. The most significant upward contribution to the tradable component came from petrol. If petrol prices had remained constant over the same period, the tradable component would have increased 2.1 per cent.

Within the non-tradable component, the most significant upward contribution to the annual movement came from the purchase of new housing and electricity, together with actual rentals for housing.

Inflation is expected to peak at 5 per cent per annum in the September quarter – well outside the 1-3 per cent target band. Looking beyond the short term inflationary pressures, there's a danger that people factor inflationary expectations into their pricing decisions and wage bargaining. Given that a number of business contracts include roll-over provisions related to producer input prices, the potential is for inflationary expectations to persist.

The Producer Price Index (June quarter 2008) showed that input prices rose a significant 5.6 per cent for the June quarter. This was driven largely by the significant increase in electricity generation and supply of 50.8 per cent (yes that figure is correct) for the quarter. On an annual basis total input prices rose a significant 11.8 per cent between the June 2007 and June 2008 quarters.

On the positive side, international oil prices have dropped around 20 per cent over the past month to currently sit at around $US115 per barrel. However, expectations of such drops flowing through into reduced fuel costs facing businesses and consumers and hence deadline inflation, will largely depend on the direction of the NZ dollar. Any further sudden depreciation against the US dollar will exacerbate current inflationary pressures.

The Reserve Bank will be in a delicate balancing position over the next few months – not wanting to exacerbate the current recession on the one hand, or to tip us towards an expectation-fuelled inflation wage/price spiral on the other.

Forecasts below show inflation likely to remain around the very top end of the inflationary band, obviously leaving almost no leeway for any shocks.

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Sep 08	Sep 09	Sep 10
Highest	5.5	2.9	3.3
Average	5.1	2.7	2.7
Lowest	5.0	2.1	2.0

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

Labour costs – wage pressures continue at historic highs

Most recent outcome: +3.5% -- year-ended June 2008

The Labour Cost Index (LCI) recorded an increase of 3.5 per cent in salary and wage rates (including overtime) for the June 2008 year. This is the highest annual increase recorded since the series began in the December 1992 quarter. By comparison, the Quarterly Employment Survey (QES) average total hourly earnings increased 5.2 per cent in the year to the June 2008 quarter.

In the LCI, salary and wage rates (including overtime) increased 0.8 per cent in the June 2008 quarter. This followed rises of 0.7 per cent in the March 2008 quarter and 1.1 per cent in the December 2007 quarter.

While public sector wage growth rose by a moderate 0.6 per cent for the June quarter, annual growth has increased by 3.7 per cent, with the local government component increasing 4.5 per cent over the same period. As widely accepted, this will put stronger pressures on the private sector to match rises being achieved in the public sector.

As a recent report: *Public sector fat cats?"* by University of Waikato Management School economist John Gibson states, there is a significant gap (an average of 17 to 21 per cent) between pay rates in the public and private sectors for "similar" jobs. This gap will tend to encourage movement from the private sector to public sector and is possibly one of the many reasons for New Zealand's reasonably mediocre productivity performance over recent years.

Forecasts are that wage inflation has peaked over the June quarter and will now decline in light of a softening labour market and the fact that firms are now reporting less difficulty in finding staff. Rising unemployment could put a damper on wage demands. There are significant pressures both pushing inflation up and pulling it down. The danger is that businesses and employees will build expectations of current high headline inflation into their pricing/wage bargaining strategies which may not be warranted or justified 6 months down the track.

Forecasts: Labour cost index percentage change

	Years ending		
	Sep 08	Sep 09	Sep 10
Highest	3.7	3.6	3.3
Average	3.5	3.1	2.7
Lowest	3.4	2.8	2.4

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

Employment – official statistics show a yo-yo effect but underlying trend is down

Most recent outcome: +0.7 per cent -- year-ended June 2008

While the bottom appeared to have dropped out of the labour market according to the March 2008 quarter Household Labour Force Survey (HLFS), we earlier cautioned about reading too much into the result as this did not stack up with what other surveys were saying, and indeed what appeared to be happening at the coalface. We are pleased now that the results for the June quarter have come to hand confirming our view that the March quarter results were largely a statistical "blip" or "one-off".

The significant drop in employment over the March 2008 quarter (29,000) has been basically reversed by the latest June 2008 quarter.

Seasonally-adjusted, employment increased 26,000 in the June 2008 quarter (after dropping by 29,000 over the March 2008 quarter) and the unemployment rate increased from 3.7 per cent to 3.9 per cent. The labour force participation rate increased significantly (up 0.9 percentage points on the March quarter) to reach 68.6 per cent. However this only restores the participation rate to where it was at the end of 2007 given that the participation rate dropped 0.9 percentage points to 67.7 per cent in March 2008.

While there is no readily apparent reason for the somewhat strange results for the March 2008 quarter, it does mean that the result for the June 2008 quarter paints a rather positive picture compared to the reality. In reality the labour market has stalled and negative employment growth is likely over coming quarters, along with rising unemployment.

Most forecasts are predicting the unemployment rate to continue to edge upwards, placing itself at over 5 per cent by September next year as outlined below.

It is possible that the labour force participation rate will increase substantially over the next couple of quarters. The increase will result from stretched household budgets as individuals seek to boost household income to perhaps tide them over a difficult period in terms of general household costs. There may also be perceptions of reduced net wealth as a result of a housing market on the decline. Ironically, this means that at a time when employment may be more difficult to obtain, increasing numbers of people will try and enter the labour market thereby forcing up the official measure of unemployment.

Offsetting this is the possibility that employers may 'hoard' skilled labour to some extent during the current downturn, simply through the fact that the transaction and transition costs of recruiting can be significant making employers reluctant to release much labour at this stage.

Forecasts: Unemployment % (HLFS)

	Quarter		
	Sep 08	Sep 09	Sep 10
Highest	4.7	5.6	5.7
Average	4.3	5.2	5.1
Lowest	4.1	4.8	4.1

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

Interest Rates (90-day bill rate) – easing continues

Most recent outcome: 8.15 per cent as at 26 August, 2008

Overdraft and mortgage interest rates generally move in line with the 90-day bill rate, which is in turn heavily influenced by the Reserve Bank's OCR (although these may be at variance if the market prices in future increases or decreases in the OCR).

The forecasts below point to reductions in interest rates by 2009, although this is not a foregone conclusion. There is still the possibility of interest rates remaining high for some time as outlined earlier in this commentary.

The extent of NZ's external imbalance leaves the country vulnerable given that international investors are re-pricing risk and credit is becoming internationally more expensive in light of recent events. In this respect, the large external deficit leaves NZ susceptible to a change in investor sentiment as the country relies heavily on external funding for its investment needs. With banks obtaining around a fifth of their money from offshore, it is a moot point whether there is any chance of significant declines in interest rates. We do not necessarily share the optimism of some commentators who are predicting further significant cuts in both the OCR, and more importantly, the cost of capital facing final consumers.

Forecasts: Interest Rates (90 day bills)

	As at end of		
	Sep 08	Sep 09	Sep 10
Highest	8.2	7.6	7.6
Average	8.1	6.8	6.7
Lowest	8.0	5.8	6.2

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

Exchange Rates – slip-sliding away

Most recent outcome: NZD = US$0.704 as at August 26 2008

NZD = AU$0.816 as at August 26 2008

TWI = 65.7 as at August 26 2008

Market expectations are for the NZ dollar to struggle against the currencies of our major trading partners over the next year or two. However, this will very much depend on New Zealand's economic growth and, particularly on inflation – the factor that has resulted in significantly higher interest rates in NZ and the rest of the world and to some extent has underpinned the NZ dollar.

The current uncertainty surrounding global growth prospects and their implications for NZ is reflected in the wide range of forecasts for the NZ dollar over the next couple of years. While expectations are for a significant drop over time, when and by how much are certainly the subject of much debate. Clearly with changing global circumstances, forecasting exchange rates is fraught with difficultly.

AUD (cents)			
	Sep 08	Sep 09	Sep 10
Highest	0.78	0.77	0.81
Average	0.76	0.75	0.78
Lowest	0.74	0.72	0.75

USD (cents)			
	Sep 08	Sep 09	Sep 10
Highest	0.77	0.75	0.71
Average	0.75	0.68	0.65
Lowest	0.73	0.64	0.62

TWI			
	Sep 08	Sep 09	Sep 10
Highest	67.8	65.7	65.1
Average	66.4	62.7	62.9
Lowest	65.1	59.6	61.1

Part 2: The Australian Economy

Monitoring the performance of the Australian economy is critical in the first instance because Australia's performance provides a measure of how well New Zealand exporters are likely to fare; a stronger Australian economy will generally 'suck in' imports. Monitoring also provides an indication of the likely strength of competition from Australian sourced products on the domestic market.

While the Australian economy is still performing reasonably well, there are significant pressures being bought to bear on it of late. It could be argued that in part the problem is that Australian is very much a split economy. The mining boom has continued to bring wealth in the west while pushing up the Australian dollar, thus impacting on the competitiveness of its manufacturers. This has now changed of late as a result of international investors moving out of strong commodity currencies (such as Australia's) and back into stock currencies such as the US and Euro. However, strong confidence in the mining sector is now easing after a prolonged period of strong growth. The outlook now is for reduced growth.

2.1 Economic Growth (GDP)

Most recent outcome: +3.6% for the year-ended March 2008.

Forecast 2008: +2.8

Source: *The Economist*

Australia's annual GDP continues to ease, with forecasts pointing to growth coming down to under 3 per cent for 2008.

Some key recent economic statistics:

- Real retail sales up 3.7 per cent in June 2008 compared with June 2007.
- New motor vehicle sales down 0.6 per cent for July 2008 compared with July 2007.
- Dwelling unit approvals down 4.4 per cent for June 2008 compared to June 2007.
- Employment up 2.3 per cent for July 2008 compared to July 2007.
- Unemployment rate of 4.3 per cent as at July 2008 – the same as July 2007.
- Participation rate of 65.3 per cent as at July 2008 – up from 65.0 per cent in July 2007.

The Australian PMI continues its decline, currently sitting at 46.9 as at July 2008.

2.2 Headline Inflation

Most recent outcome: +4.5 per cent for the year-ended June 2008

Forecasts: 2008: 4 per cent
Source: The Economist

After holding interest rates at 5.25 per cent for a long period, the Reserve Bank of Australia has now lifted the cash rate twice in 2008 to sit at 7.25 per cent (now just 0.75 percentage differential with NZ). Despite earlier predictions of the potential for even higher interest rates, inflationary pressures have declined of late meaning the future direction of interest rates should be down – not up. The Reserve Bank of Australia is moving towards an easing bias given that it sees the Australian economy slowing noticeably.

The increases in rates earlier this year were made in order to contain and reduce inflation over the medium term, as inflation was high in 2007 and continuing to grow in 2008. However, further moderating is expected in response to slower growth in demand and pressure coming off fuel prices.

Part 3: Rest of the World

Internationally, markets are facing a significant period of uncertainty. The credit crunch continues to flow through the developed world, commodity prices continue to remain high and inflationary pressures are an international phenomenon. Forecasts of global growth rates continue to be cut.

Despite the credit crunch, many banks were still prepared to offer loans to companies for buildings and equipment, as they shifted out of the housing market. Now this has changed. Loans to companies are slowing internationally as well – a sure sign that companies are increasingly under pressure. Stronger wage growth internationally and high commodity prices have squeezed profits, and export orders have suddenly become harder to find.

With global inflationary pressures still in abundance, many countries will be welcoming lower international oil prices, indicating that for many countries, inflation has peaked.

United States

The credit crunch started with the subprime mortgage crisis in the United States, which has led to a number of write-offs and failures, directly leading to the current financial difficulties facing major American mortgage lenders Fannie Mae and Freddie Mac. While such entities are to a certain extent government backed, they have not been immune to the general downturn in the US.

The US housing market continues to drop with a significant write-down in housing asset values. More is to come with a significant number of listings on the market still unsold.

The US dollar has rallied of late, mainly on the back of gloomy British growth data and a general view of a slowing global economy which may result in a case for interest rate cuts outside the US. Crude oil prices have dropped to below $US115 per barrel helping soothe persistent worries about inflationary pressures in the US, and contributing to rallies on Wall Street.

While the Federal Reserve currently has interest rates sitting at a very low 2 per cent to try and encourage new spending and investment, the real danger is inflationary pressures that threaten to get out of control. The US, like NZ, has not been immune from rising energy costs, which is reflected in heightened inflationary pressures. The danger is that inflationary pressures become entrenched in household and company behaviour.

Despite pessimism in the US, recent data would suggest that the worst is behind them, and an improving growth outlook is now evident. However, the wave of bank failures will have ripple effects for the foreseeable future.

Euro

In many respects the credit crunch in the US has spread wider then expected yet the US has perhaps weathered the storm much better than the Eurozone. While the US certainly suffered a slight decline in GDP at the end of 2007 and has grown slowly since, Europe by contrast has suffered a significant slump in growth over the June 2008 quarter, while indications are that investment in manufacturing and services is also facing a significant downturn.

The three biggest economies in the Euro area: Germany, France and Italy have all faced a significant downward shift in business confidence. While business confidence stutters in Italy are not unusual, confidence drops in both Germany and France are of more concern. Domestic orders for German engineering services have fallen around 5% from a year ago while foreign orders fell by around 7 per cent.

A key issue facing the Euorzone is that one of its main export markets, Britain, is on the brink of recession which is not helping matters.

Japan

Japan's GDP contracted in the second quarter of 2008, underlining the impact that rising prices and weakening exports are having on the world's second-largest economy.

The latest data, across the economy remains weak. This is a reflection on a number of factors including a decreasing demand for exports, high oil and food prices, and the continuing fall-out from the US sub-prime crisis.

Growth prospects have been slashed to just over 1 per cent for 2008.

Both private and government consumption are contracting with a variety of factors dampening private consumption.

These include a weakening job market, sluggish wage growth, rising inflation, and, generally concern about the domestic political situation.

Indicators of business confidence are down with capital spending down and business confidence among major manufacturers at its worst level since 2003. Apart from weakness in domestic demand, the big issue remains rising prices associated with both energy and inputs (an almost universal problem). The corporate goods (inputs) price index rose by 7.1 per cent year on year, its highest rate of increase in 32 years. The potential for stagflation (high inflation and no or even negative growth) remains a real possibility for Japan.

Forecasts: World GDP Growth (Selected Trading Partners)

Country	*Latest*	*2008*	*2009*
Australia	3.6	2.8	2.7
Canada	1.7	1.2	1.9
Japan	1.0	1.4	1.2
United Kingdom	1.6	1.4	1.0
United States	1.8	1.5	1.2
Euro Area	1.5	1.6	1.2

Source: Economist

Forecasts: World Consumer Price Inflation (Selected Trading Partners)

Country	*2008*
Australia	4.0
Canada	2.3
Japan	1.6
United Kingdom	3.6
United States	4.4
Euro Area	3.6

Source: Economist