BUSINESS NZ

PLANNING FORECAST

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BusinessNZ

Return to Growth

Executive Summary

After 18 months of negative growth, concrete signs of growth are now re-emerging both domestically and internationally.

Financial markets have stabilised with capital flows improving at an ever-increasing rate. Markets around the world are showing positive signs of recovery and sharemarkets are, in general, going from strength to strength.

International demand is pushing up commodity prices but the improvement is not being reflected in improved returns to NZ producers, still hampered by a rising dollar against the US. A weak US dollar, largely on the back of international investors returning to more risk-based commodity currencies, is acting as a brake on any export-led recovery.

Despite significantly improved optimism from both business and consumers, the outlook for the labour market remains weak over the short to medium term and will act to constrain household consumption. On the other hand, healthy rises in net migration will boost the demand for goods and services while underpinning a revival of the housing market - a two-edged sword.

Rising demand will soak up under-utilised resources but risks placing upward pressure on non-tradeables' inflation, much of it driven by sectors of the economy that are still state or local government monopolies and not subject to competition.

While both New Zealand and international growth prospects are being revised upwards from previous pessimistic forecasts, risks remain. Wholesale moves by many governments towards insular policies and greater protectionism were an unfortunate side effect of the international recession, with implications for New Zealand and other countries heavily dependent on international trade for their livelihood.

HIGHLIGHTS

Business New Zealand's Economic Conditions Index (ECI) shows improved conditions, although the overall ECI is only just in positive territory – the first time since the December quarter 2007.

The New Zealand economy is now growing again after 18 months of negative growth. However, growth is likely to be tentative in 2010 before improving in the out-years.

While overall prospects for the NZ economy are improving by the day, there are still risks to the strength of the recovery – notably the continued rising value of the NZ dollar against the $US, reflecting ongoing weaknesses in the US economy.

The inflation genie is expected to remain well within the bottle for the next year or so although non-tradeables' inflation remains a risk.

The unemployment rate may hit 7.5% by 2010, but forecasters have revised downwards earlier more adverse outcomes.

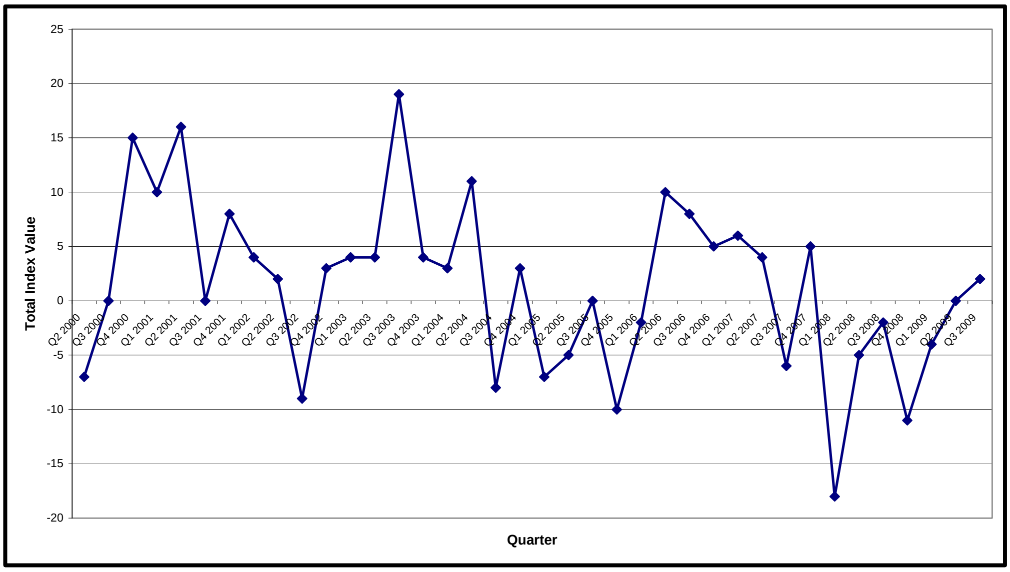
Part 1: The NZ Economy – Where are we Now?

Business NZ Economic Conditions Index (ECI)

The overall Business NZ Economic Conditions Index (a measure of the major economic indicators) sat at 2 for the September 2009 quarter, an improvement of 2 from the previous quarter and up 4 from the -2 recorded for the September 2008 quarter.[1]

The ECI is now in positive territory – the first time since December 2007 **-** with the upswing driven largely by strong growth in both business and consumer confidence. However, labour market activity remains in the doldrums.

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 -2, an improvement of 2 on the last quarter and the same as a year ago. Negative economic growth since the March 2008 quarter should end this quarter with a return to fragile growth in the final quarter of 2008. The global economic and financial crisis has stabilised with improved international investor confidence, but the improvement has been somewhat dented by the need for governments around the world to unwind some of the more rushed and draconian interventions implemented over the last year.

Monetary policy/pricing indicators sit at 1, down 2 on the June quarter and down 1 on a year ago. In light of improving world demand, long-term interest rates are starting to increase while the exchange rate has picked up significantly on the back of a weak US dollar. A steady improvement in world commodity prices is evident with the ANZ's Commodity Price Index showing significant improvements over the last 6 months. Unfortunately, that

[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 negative.

improvement is not, owing to a rising NZ dollar, currently reflected in improved prices to NZ producers. The implications for the competitiveness of NZ exporters if the dollar continues to rise are considerable.

Business/consumer confidence indicators sit at 9, an improvement of 4 on the June 2009 quarter and an improvement of 11 on a year ago. Deep levels of pessimism apparent in the first quarter of 2009 have evaporated and a number of recent surveys show both business and consumer confidence rising strongly. Notwithstanding rises in general confidence, companies within sectors have vastly different confidence levels which tend to be disguised when broad sector confidence indicators are considered. Consumer confidence is also mixed. Reductions in debt servicing costs are impacting positively on households although continued nervousness about employment prospects is making people cautious of consumption expenditure, impacting adversely on some sectors. On the other hand, net migration is lifting strongly and this will help breathe new life into the housing market and boost the general demand for goods and services.

Labour market indicators sit at -6, a deterioration of 2 on the previous quarter and down 6 on a year ago. Given the general lag between a decline in the economy and labour shedding, it is perhaps ironic that the largest decline in employment (and the associated highest rate of unemployment) is occurring when the economy is starting to climb out of recession. Consequently, further significant employment losses are inevitable.

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

1.1. Economic growth (GDP) – return to positive outcomes

Official data sometimes does not provide a useful reflection of where the economy is at - nothing to do with the quality of the data, simply the delay in official data hitting the market place.

Growth has been negative in New Zealand since the March quarter of 2008 but with wide-spread expectations of a return to growth in the final quarter of this year, tentatively at first before rising significantly in 2011 as outlined in a number of forecasts.

There are several reasons to be reasonably positive about the New Zealand economy's growth prospects.

First, world demand is recovering - reflected in higher commodity prices although tempered somewhat by exchange rate risks.

The ANZ Commodity Price Index recorded its sixth consecutive monthly rise with the 4.3 percent rise in August the strongest monthly gain since the recent February low. The cumulative lift in the commodity price index since February has been 12 percent, although a stronger NZ dollar more than wiped out the recent price gains with prices down 14 percent since February when converted into NZ dollars.

	World Price Index	Monthly % Change	Annual % Change	NZ$ Index	Monthly % Change	Annual % Change
Aug 2004	150.7	0.9	24.3	123.3	-0.3	13.2
Aug 2005	153.9	-0.9	2.1	118.0	-2.7	-4.3
Aug 2006	153.0	0.5	-0.6	130.4	-1.7	10.5
Aug 2007	208.6	1.4	36.3	156.9	10.0	20.3
Aug 2008	216.0	-3.4	3.5	166.4	2.0	6.1
Aug 2009	166.7	4.3	-22.8	130.6	-0.6	-21.5

Source: ANZ Commodity Price Index NZ – 3 September 2009

Second, as business confidence returns, firms will need to invest and restock depleted inventories.

Third, significant monetary and fiscal stimulus over the past couple of years will provide greater opportunities for business growth. In the case of fiscal stimulus, the large number of infrastructure projects either on the go or awaiting the go ahead will provide many infrastructure companies with new opportunities. For households, relatively 'loose' monetary policy conditions, reflected in relatively low interest rates by historical standards, provide greater opportunity to service and perhaps more importantly, reduce debt levels and their associated risks.

Fourth, greater consumer confidence is starting to be reflected in a return to greater expenditure as evidenced by recent electronic card transactions and slow improvements in building activity and car registrations.

Consumer demand will be linked not only to the future direction of interest rates, but more particularly, to the employment outlook. While employment growth is currently negative, there are signs that unemployment projections will be reduced, while a number of surveys show that employers have either decided not to reduce their current staffing levels or in some cases have started re-hiring.

Fifth, the significant increase in net migration will not only boost demand for housing but also demand for goods and services in general.

But despite all the positive implications for future growth, there are still some potential flies in the ointment.

First, the future direction of the exchange rate (particularly against the US dollar) could act to largely offset returns to producers from increased international commodity prices. Recent results from the ANZ commodity price index show that while international prices have risen significantly, this has been more than offset by a rising NZ dollar against the US. The future direction of the $NZ will therefore be very important.

Second, while inflation currently appears to be dead and buried, there are hints that it could easily be resurrected as a result of rising housing demand and a resurgent of interest in taking on greater household debt, the result of the low interest rates projected for the foreseeable future. Pressure on the Consumers Price Index (CPI) is also likely to come from the significant cost increases (rates) associated with the provision of monopoly services via local government, while massive increases in accident insurance (ACC) are possible unless radical mechanisms can be put in place to reduce continued cost blow-outs. What it is important to understand is that such costs are not a result of the vagaries of international markets (tradeables' inflation) but a direct result of a lack of discipline or incentives on service provision by state or local government-run monopolies (non-tradeables inflation). A concerted effort is required to open up such monopolies to competition to ensure that cost pressures are contained. Any moves towards re-igniting inflationary expectations will bring a swift response from the Reserve Bank, likely to be negative for the direction of interest and possibly exchange rates.

Third, given the huge fiscal and regulatory support packages around the world introduced in response to the global crisis, a crucial element for long-term economic growth will be the unwinding of these packages and what the consequences will be for business investment and confidence. Given the severity of some packages and their fiscal ramifications, many governments will need to make significant cutbacks as they try and revert to more sustainable monetary, regulatory and fiscal polices.

While there are obviously downside risks to New Zealand's future growth projections, on balance, the outlook can only be described as reasonably bright.

Forecasts: Real GDP % Growth

	Years Ending		
	Sep 09	Sep 10	Sep 11
Highest	-2.4	1.3	4.0
Average	-2.5	0.7	3.6
Lowest	-2.6	0.0	3.1

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

1.2 Monetary Conditions – future direction uncertain with a buck each way

Interest rates – short-term rates low, but long-term rates starting to rise

The Reserve Bank Governor kept the Official Cash Rate (OCR) at 2.5 percent at the latest review (10 September 2009) with his announcement emphasising that there are risks to the current recovery and a consequent need to keep rates at around current levels until the end of 2010.

While some sectors of the economy called for further reductions in the OCR, it is not at all obvious that these would have had any impact on interest rates. Longer-term interest rates are not influenced significantly by the OCR but by the cost of funds - deposits locally - and the cost of sourcing funds overseas.

New Zealanders' propensity to spend beyond their means and their appetite for debt necessarily requires overseas borrowing. Therefore the future direction of interest rates is likely to be up rather than down as global demand for credit increases. Escalating government debt both locally and internationally will also continue to boost long-term interest rates.

Perhaps unsurprisingly in light of the above, the 90 day bill rate is forecast to increase slightly in 2010 and show a more aggressive up-turn in 2011.

While the Reserve Bank has left the door open for a possible further reduction in the OCR (if necessary), the likelihood of any further reduction is extremely remote and would take a significant deterioration in key economic indicators and/or risks to the financial sector. Neither appears remotely evident at this stage and economic data (both quantitative and qualitative) suggests improved economic prospects almost by the day. Moreover, as mentioned earlier, further drops in the OCR will not necessarily result in an equivalent drop in the cost of capital to businesses given risk factors and the cost to banks of borrowing on international wholesale markets.

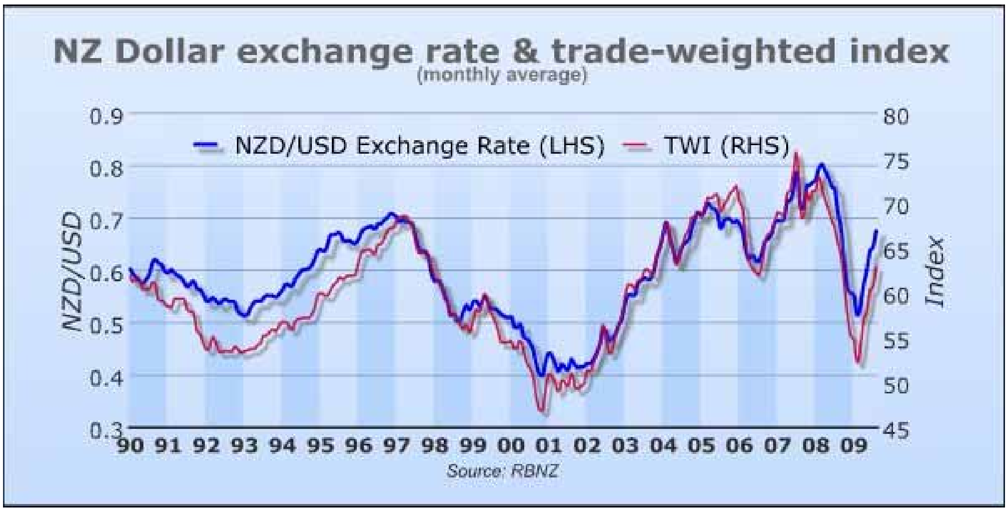
Forecasts: Interest Rates (90 day bills)

	As at end of		
	Sep 09	Sep 10	Sep 11
Highest	2.8	3.7	6.3
Average	2.7	3.4	5.8
Lowest	2.6	2.8	5.5

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

The New Zealand Dollar – onward and upward?

There has been a significant recovery of the New Zealand dollar over the last two quarters mainly due to the fact that riskier commodity currencies such as those of Australia (and indirectly NZ) have picked up demand. However, in some respects, the current appreciation of the NZ dollar has more to do with the comparative weakness of the US dollar rather than the inherent strength of the NZ economy. The Reserve Bank Governor has expressed concern that a weakening US dollar is largely dictating the value of independent currencies.



Notwithstanding the above, some informed commentators have questioned the validity of the NZ dollar's rise; they believe the dollar is getting ahead of itself and the rise is not justified by economic fundamentals. However, when tracked against the Australian dollar, the NZ dollar has hardly moved of recent months.

Currency volatility is an issue not just for New Zealand but for other major trading economies, suggesting that there is limited ability to ameliorate the impact of the problem domestically. The actual cause is more fundamental given the US dollar is the major reserve trading currency and the trading world has to wear the impact of a poorly performing American economy, not helped by the day-to-day uncertainties of policy settings.

In this respect, the problem is likely to persist until the US economy improves or the US dollar ceases to be the major reserve currency.

Forecasts below show a reasonable variation in expected exchange rates against Australia and particularly, the United States over the next year. However, forecast exchange rates for NZ against both the Australian and US dollar are much more convergent when looked at out to 2011, even more so when looking at the trade-weighted index (TWI). There could therefore be significant movements (up or down) over the next year as currencies settle down and economic conditions improve after the turbulence of the past year or so.

	AUD (cents)		
	Sep 09	Sep 10	Sep 11
Highest	0.810	0.843	0.850
Average	0.804	0.795	0.811
Lowest	0.800	0.720	0.784

	USD (cents)		
	Sep 09	Sep 10	Sep 11
Highest	0.690	0.750	0.710
Average	0.669	0.693	0.694
Lowest	0.645	0.600	0.670

TWI			
	Sep 09	Sep 10	Sep 11
Highest	63.7	70.5	67.4
Average	62.6	65.0	65.7
Lowest	61.2	57.0	63.7

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

Inflation - no concern currently but watch out for pressure from the non-tradeables' sector

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 2009 CPI rose 0.6 percent after a rise of 0.3 percent in the March quarter. Annual inflation is now 1.9 percent - well within the RBNZ's target band of 1 to 3 percent.

The Reserve Bank is reasonably confident that annual inflation will remain well within the target band going forward, with only minimal increases in quarterly inflation for the future.

Given the continued expected improvement in inflation figures, forecasts below show inflation increasing slightly out to 2011 (average of 1.9 percent) with some predicting an annual inflation result as low as 1.2 percent in 2011.

While most business people would be very happy if such forecasts played out in reality (since inflationary pressures can result in higher interest and exchange rates), for two important reasons concern remains at the potential for inflationary pressures to arise over the medium term.

First, increased net migration, while positive in respect to the increasing demand for goods and services, will put added pressure on a housing market already showing significant signs of recovery both in terms of prices and numbers of houses being sold. Given a relatively depressed level of building activity over the past two years, there is not a large amount of new housing stock coming on stream, raising the potential for inflationary pressures in this market.

Second while tradeables' inflation is firmly under control (assisted to some extent by a rising $NZ against most trading partners and declines in the international price of petrol over the past year), non-tradeables' inflation is potentially an issue. While tradeables' inflation is now hovering slightly above zero (0.2 percent) on an annual basis, non-tradeables' inflation still exceeds 3 percent per annum, with several areas of expenditure blow-out potentially adding to inflationary pressure over coming months. First, local government rates rises continue to be a problem and second, blow-outs in accident compensation (ACC) could see massive future premium rises unless radical steps are taken to reduce costs.

Notwithstanding short-term variations in the CPI components, the continued strength of non-tradeables' inflation reinforces the need to ensure the economy is as competitive as possible by removing government and its various agencies' current monopoly on the provision of some goods and services.

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Sep 09	Sep 10	Sep 11
Highest	1.4	2.2	2.7
Average	1.2	1.5	1.9
Lowest	0.9	1.2	1.2

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

1.3 Business and Consumer Confidence – on the rise

Business confidence – going from strength to strength

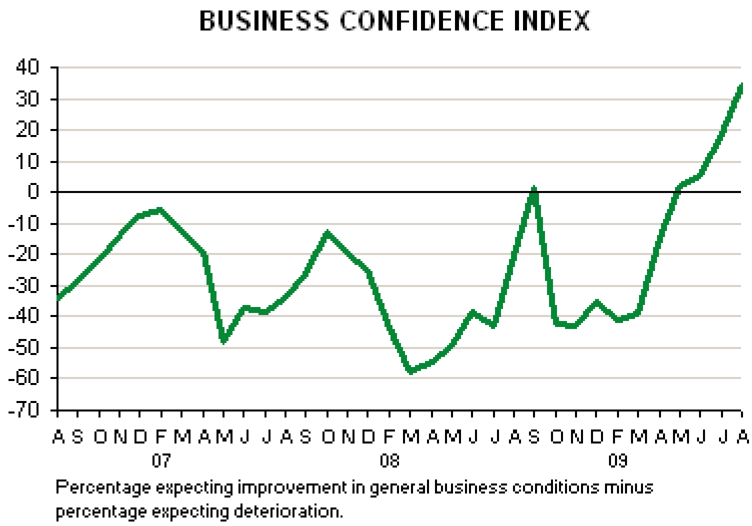
Both business and consumer confidence have continued to go from strength to strength over recent months. The turnaround in confidence since the start of this year has been quite staggering to say the least. While general business confidence is important, from an economic perspective what is more important is firms' own activity expectations. Here the news is generally all good.

The National Bank's Business Outlook (August 2009) showed confidence surging once again with a net 34 percent of respondents expecting better times over the next 12 months, up 16 percentage points on July.

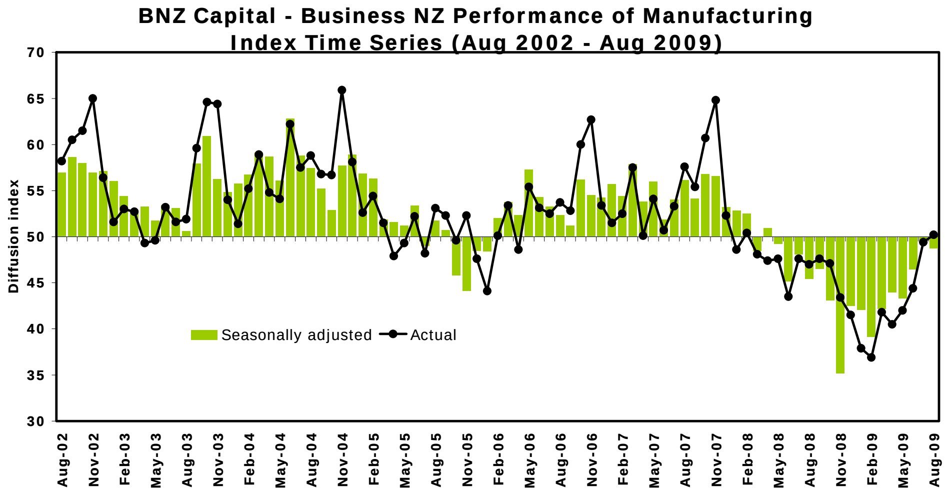
More importantly, firms' own activity expectations are at close to a five-year high with a net 26 percent expecting better times ahead. All the major sectors surveyed show significant improvements from their earlier negative status. Even employment intentions, still slightly negative, have improved significantly.

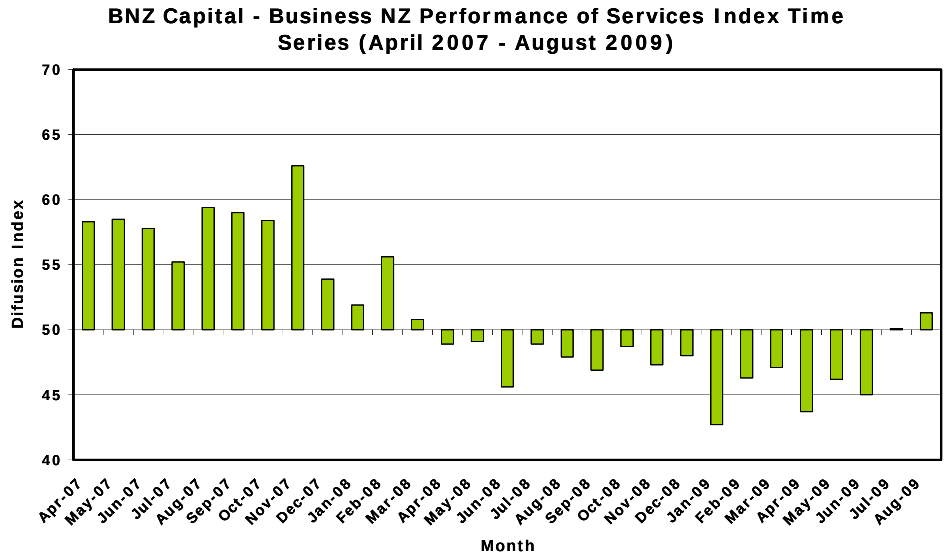
Business confidence indicators have proved time and time again to be good leading indicators of future economic activity and growth. In this respect, the latest business confidence indicators are good news. Reinforcing this good news is the fact that almost all surveys of business confidence are pointing in the same upward direction giving credence to the view that the return to growth is largely across all sectors and not narrowly based.

National Bank Business Confidence Index



The continued improved outlook can also be seen in Business NZ's own surveys, such as the BNZ Capital – Business NZ Performance of Manufacturing (PMI) and Performance of Services (PSI) indexes. Both show activity now in the black (on an unadjusted basis) after being firmly in negative territory for the best part of 18 months. The key forward looking sub-index of the PMI, new orders, has now been in positive territory for the past three months.





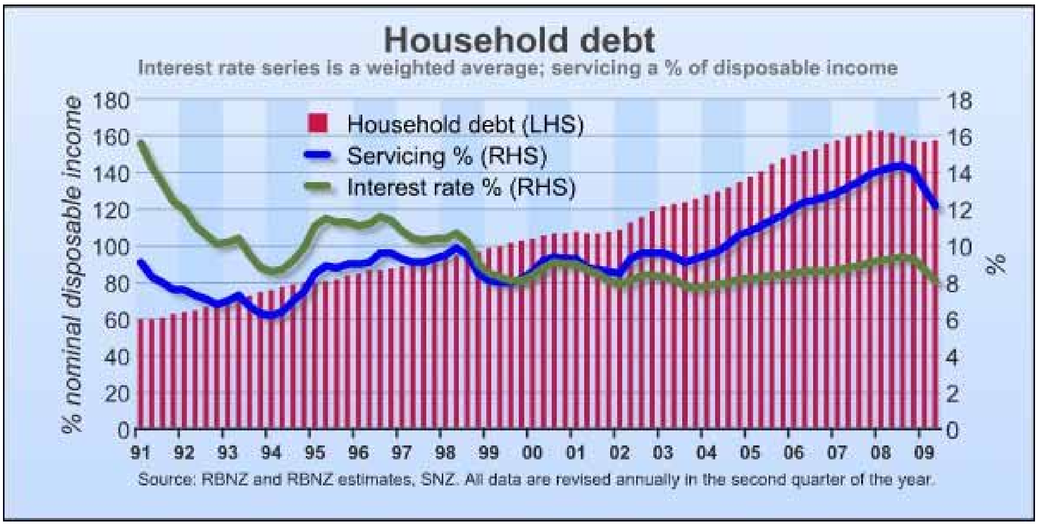
Despite the positive news about business confidence and the future direction of economic growth, it is important not to forget the potential risks to future growth referred to earlier; we must not get too far ahead of ourselves.

Consumer confidence – positive if somewhat constrained

Consumers are increasingly positive having been generally in negative territory for much of 2008 and the first quarter of 2009. Significant reductions in interest rates, reduced inflationary pressures and improved economic perceptions have more than offset any consumer pessimism generated by a relatively weak employment outlook and associated rises in unemployment.

Activity in a number of sectors e.g. housing, retail and data on electronic transactions has generally improved since that time which should further help to bolster consumer confidence. Many forecasters have revised downwards their previous pessimistic outlook on employment growth and unemployment, providing another likely boost to consumer confidence.

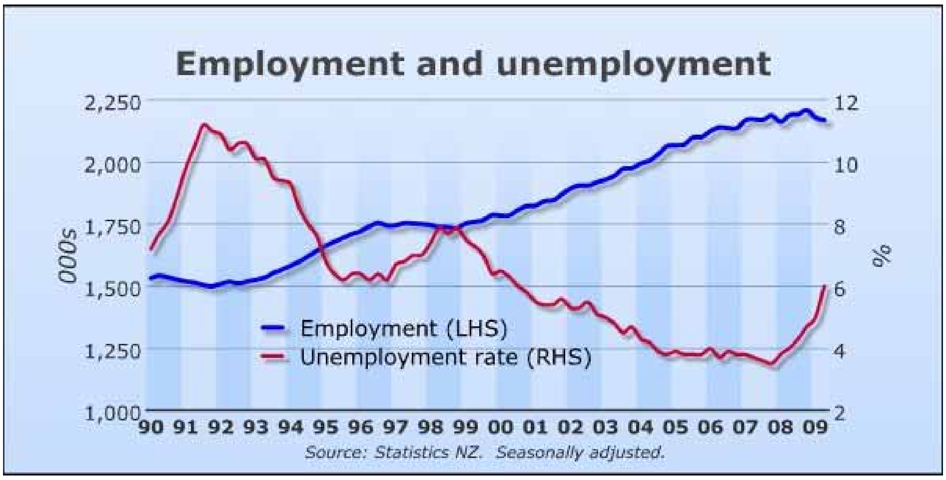
But despite general improvements in consumer confidence, the big gorilla in the room is still the significant level of household debt. While there has been a slight reduction in household debt levels since the start of 2008 (down from 162 percent of household disposable income to 157 percent as households rein in expenditure and reduce debt on the back of declines in debt servicing (interest) costs), debt levels remain stubbornly high - a continuing risk given the likely future direction of interest rates.



1.4 Labour markets – down but not out

Employment – unemployment increasing, but not at the rate many expected

Pessimistic forecasts earlier this year had unemployment peaking at over 8 percent in 2010 with some suggesting that unemployment would be in double figures before long. Statistics NZ's Household Labour Force Survey (HLFS) shows the official unemployment rate (for the June quarter) as 6 percent but it is likely that the current September quarter rate will be around 6.5 percent. Moreover, there is no doubt that further rises in unemployment are inevitable as the continued shake-out of the labour market continues. However it is not all bad news.



A number of business opinion surveys show that many employers have stopped shedding labour and indeed, in some cases, are starting to rehire. Projections of future unemployment rates have been revised downwards as a result, with most reputable forecasting agencies reporting that unemployment is likely now to peak at around 7.5 percent in 2010, slowly moderating thereafter.

A survey by Veda Advantage of small to medium sized businesses indicates that around 95 percent of those surveyed believe their employee numbers will remain the same or increase over the next six months.

The BNZ Capital – Business NZ PMI (August 2009) identifies employment activity, while still negative, as improving substantially from the very pessimistic levels of under 40 for February and March 2009. The current activity level of 46.9 is now at its highest since May 2008 with a possible return to expansion by the end of this year. Other respected surveys such as the NZIER's Quarterly Survey of Business Opinion (QSBO) and the National Bank's Business Outlook show the tide turning with a less pessimistic outlook from respondents than earlier surveys on the employment front. The Westpac Mc Dermott Miller Employment Confidence Index also indicates increased optimism in respect to future employment expectations.

The Department of Labour's Job Ad Series shows a continuing decline in the number of Internet Job Ads but that newspaper Job Ad numbers have bottomed out with some marginal improvement, although from a relatively low base by recent historical standards.

The NZ Treasury expects the 2009 June quarter will likely be the last quarter of economic contraction; and that signs of growth in the economy mean activity levels and labour demand will exceed those outlined in earlier Budget forecasts. *"This is likely to result in a lower peak in the unemployment rate – perhaps around 7.5% next year, compared with a peak of 8% in the budget forecasts."* This would see numbers unemployed peaking at less than 150,000, around 12,500 fewer unemployed than previously forecast.

Notwithstanding all the positive news and the fact that the New Zealand unemployment rate is much less than that of many of our trading partners, 6-7 percent unemployment does represent a huge loss of resources, not to mention the associated costs of social welfare assistance. Concerted efforts are required to encourage rapid re-integration into the workforce wherever possible.

Forecasts: Unemployment % (HLFS)

	Quarter		
	Sep 09	Sep 10	Sep 11
Highest	6.6	7.7	7.5
Average	6.5	7.5	6.9
Lowest	6.3	7.1	6.6

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

Labour costs – further signs of trending down

The general pessimism about short-term labour market conditions is continuing to impact on wage and salary rates.

On an annual basis the LCI showed salary and wage rates (including overtime) peaking at a 4 percent annual rise for the September 2008 quarter (the largest since the series began in the December 1992 quarter). Since that time, wage and salary rates have continued to increase, but at a much lower rate.

Given the declining labour market outlook, there are likely to be restraints on wage demands as individuals and businesses adjust to tighter economic conditions. This includes elements in the public sector that have tended of recent years to lead the drive for increased salaries and is backed up by a number of business opinion survey. The surveys show that, in general, employing both skilled and unskilled staff has been easier than for some time, although there are tentative signs that this easing may have slowed of recent weeks.

Forecasts below indicate that total labour cost inflation is expected to moderate further over the coming year before increasing slightly in 2011, consistently with expectations of negative employment growth and rising unemployment for the next 9-12 months.

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

	Years ending		
	Sep 09	Sep 10	Sep 11
Highest	2.1	1.9	2.4
Average	2.0	1.6	1.7
Lowest	1.9	1.3	1.3

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

Net migration flows – flows showing steady improvement

Although net migration (a good leading indicator of general economic activity for the future) has been declining over the last few years; there has been a significant up-turn in the last six months. Seasonally adjusted net migration was 15,642 in the August 2009 year, up from 4,938 in the August 2008 year. The latest figure is the highest annual net migration total since the November 2004 year (16,300). The net gain in the year ended August 2009 has been largely driven by reductions in the number of people leaving New Zealand rather than greater numbers of people coming here. This may reflect the fact that economic conditions in New Zealand are now more positive than many other countries overseas.

Permanent and long-term (PLT) departures decreased by 2,000 in the month of August 2009, including 1,800 fewer departures to Australia and 200 fewer to the United Kingdom.

Significant upturns in net migration will boost the general demand for goods and services, while putting some upward pressure on the housing market.