BUSINESS NZ

PLANNING FORECAST

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BusinessNZ

NZ Economy – subdued

Executive Summary

The statement was made recently that the New Zealand economy has about as much life as an Australian back line move during a Bledisloe Cup game!

That statement might seem unduly harsh given there are now strong signs of growth associated with the Christchurch rebuild and with the housing up-turn in Auckland. But aggregate figures tend to suggest that while there are significant pockets of optimism, this is not being reflected in aggregate employment or output growth.

The latest BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and Performance of Services Index (PSI) - for August 2012 - show that, overall, activity is more or less stagnant – with neither strong evidence of growth nor strong evidence of decline.

Business and consumer confidence continues to remain in positive territory, although as stated a number of times, both business and consumer survey results tend to be a much weaker forward looking indicator than they were pre-2008. Uncertainty is now the new certainty with which both businesses and households will need to get to grips with over coming years.

Notwithstanding the above, when compared with the rest of the world, New Zealand is in pretty reasonable shape with relatively low government debt by international standards and relatively sound monetary and fiscal policy settings which have helped buffer us from the fall-out associated with the radical fiscal and monetary policy stimulus packages evident in some overseas markets.

News from Europe shows sentiment there continuing to be negative, while the power house of China has experienced further slippage of late. The latter will have implications for the Australian economy, particularly in respect to the demand for minerals and could, in turn, affect the NZ economy given this country's strong trading relationship with Australia.

There has also been talk about reduced demand impacting on international commodity prices, although recent global dairy trade auction results have shown an increase in prices – the highest since early April 2012. Despite this, Fonterra has reduced projections for dairy payouts in the current 2012/13 season, a reduction which to some extent is likely driven by a continued high dollar relative to the US.

However, it is not all bad news on the commodities front. Drought conditions in the United States have significantly affected grain prices while output there is likely to be down. This is bad news for US producers and households but over the coming months, will be good news for NZ producers.

HIGHLIGHTS

The BusinessNZ Economic Conditions Index (ECI) sits at -2 for the September 2012 quarter, the same as the previous quarter but up 2 on a year ago. Aggregated data across the economy effectively show little change on a year ago.

The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and Performance of Services Index (PSI) for August 2012 show activity as more or less in no man's land – neither showing strong evidence of growth nor of decline.

The global economic growth outlook is subdued with reduced demand impacting adversely on NZ producers although drought conditions in the US could be a silver lining for NZ over the coming months.

The advantage of relatively solid demand for NZ commodities is being lost somewhat because of the strength of the $NZ compared with that of the $US. This is not from any inherent weakness in NZ's monetary policy framework but is in no small part due to the continued pump-priming of monetary policy, particularly in the US.

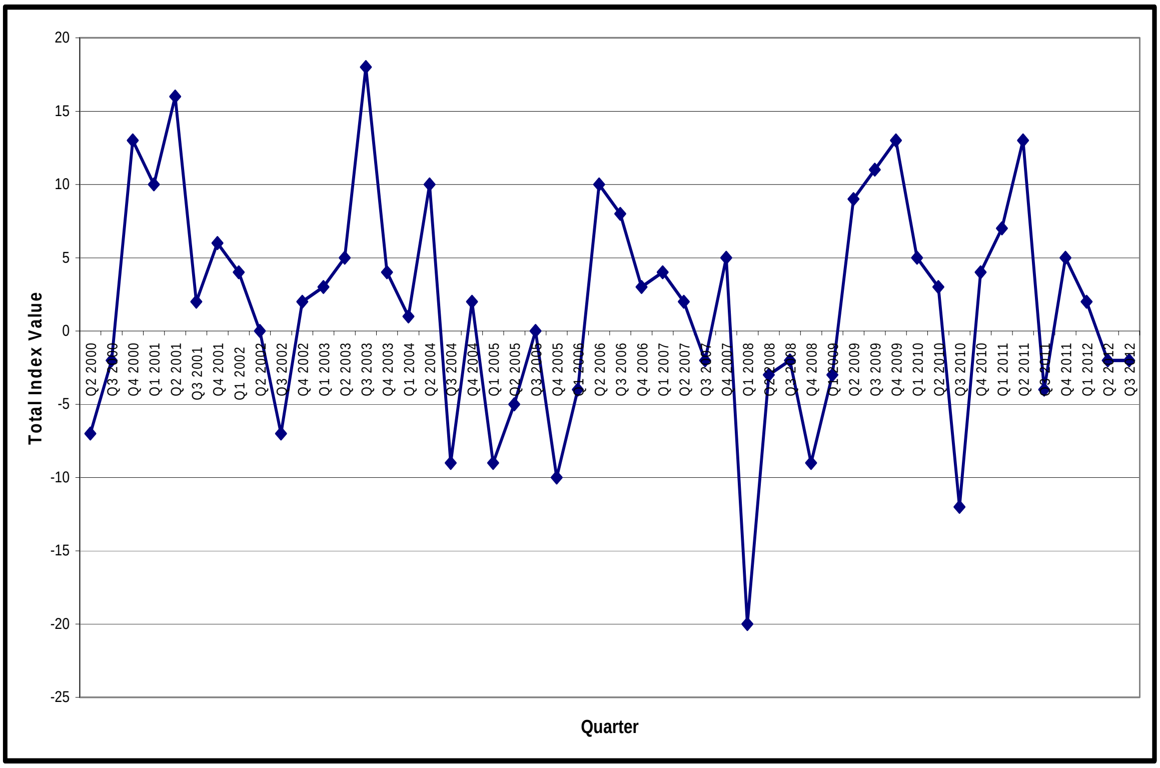
Households and businesses continue to take a cautious approach to new investment with debt reduction still a high priority for households and businesses alike. Debt reduction is assisted by historically low interest rates and there is little chance of interest rate hikes in light of generally lowering inflationary expectations.

Part 1: The New Zealand economy – where are we now?

BusinessNZ Economic Conditions Index (ECI)

The overall BusinessNZ Economic Conditions Index (a measure of the major economic indicators) sits at -2 for the September 2012 quarter, the same as the previous quarter but an improvement of 2 on a year ago.[1]

Overall Economic Conditions Index (ECI)



Source: BusinessNZ

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

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

In terms of the ECI sub-groups:

Economic growth/performance indicators sit at -4 for the September 2012 quarter, the same as the last quarter but an improvement of 2 on a year ago. While international commodity prices have had an impact on NZ's terms of trade, both trade volumes and prices have remained reasonable, and indeed have improved of late. This is likely to be caused, in part, by ideal growing conditions over the last season as these relate to agricultural production.

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

<u>Monetary policy/pricing indicators</u> sit at -4 for the September 2012 quarter, down 4 on the last quarter and down 1 on a year ago. Inflationary pressures remain subdued with historically low interest rates likely to continue over the medium term. However, this situation is offset to some degree by subdued commodity prices in light of weaker international demand and by ad hoc monetary policy developments overseas e.g. continued quantitative easing in the US, which have put unjustified upward pressure on the NZ dollar.

<u>Business/consumer confidence indicators</u> sit at 5 for the September 2012 quarter, up 2 on the previous quarter and up 5 on a year ago. Business confidence shows strong pockets of optimism in some sectors and regions but is still broadly subdued when looked at across the economy as a whole.

<u>Labour market indicators</u> sit at 1 for the September 2012 quarter, up 2 on the previous quarter and the same as a year ago. While aggregate data show little change, there are strong pockets of growth e.g. in Christchurch as the rebuild drive starts to take-off.

<u>Part 2: The New Zealand economy – where are we going?</u>

1.1 Economic growth (GDP) – mediocre

Economic growth is forecast to be around 2.5 to 3 percent per annum out to September 2014 as outlined below.

Forecasts: Real GDP % Growth

	Years Ending		
	Sep 12	Sep 13	Sep 14
Highest	2.5	3.6	3.0
Average	2.4	2.9	2.6
Lowest	2.2	2.4	1.7

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

In normal circumstances, such a forecast growth rate could be considered mediocre at best. However, in the context of the global economy, NZ's prospects are reasonably good compared with those of many other developed economies.

Standard and Poor's in their recent report on NZ's credit rating (2 August 2012) succinctly stated that the country has three major strengths and three major weaknesses which are affecting its credit rating. The strengths are seen as:

- Fiscal flexibility underpinned by moderate, albeit rising, general government debt and a long-standing commitment to fiscal discipline
- A resilient economy, with flexible labour and product markets
- Strong political and economic institutions conducive to swift and decisive policy reform

In terms of weakness, Standard and Poor's identified the following factors:

- High external debt and weak external liquidity
- Vulnerability to swings in commodity income
- High household debt and an adverse demographic profile

While these strengths and weaknesses are well understood, there are a number of factors which could impact positively or adversely on NZ's growth prospects over the coming year or so.

The potential positives are:

First, the rebuild of Christchurch, which, after significant delays, appears to be gathering momentum as outlined in a number of official and unofficial statistics. The sheer amount of money which will be poured into that region (some estimate around $30 -$40 billion over time), is a big factor which will make or break the growth forecast.

Second, building activity, beyond Christchurch, is also starting to pick up although offset somewhat by slow non-residential activity. Nevertheless, the trend for overall building activity continues to rise from the low point experienced in the September 2011 quarter. Earthquake strengthening of buildings outside Christchurch, particularly in Wellington, is increasingly being undertaken to gain compliance with earthquake building codes. This will likely provide ongoing activity for a number of years as building owners work through possible options.

Third, international commodity prices after taking a hit over the last year or so, are now stabilising with some improvements evident of late e.g. in terms of the recent global dairy trade auction. Drought conditions in the United States have significantly affected grain prices with output likely to be down. This is bad news for US producers and households but over the coming months, will be seen as good news for NZ producers.

Fourth, as alluded to by Standard and Poor's, NZ has generally sound political and economic institutions, along with relatively flexible labour and product markets and these assist in the adjustment process. Compared with many other countries with fiscal, monetary and regulatory policies under significant stress, NZ is doing pretty well, so it is important not to get too down about the country's position in the world.

The potential negative impacts are:

First, the world economic outlook continues to look decidedly shaky and is impacting on NZ's major trading partners, including China and Australia, which to date, have been largely immune from the global fall-out associated with the EU and the USA.

News from Europe shows sentiment there continuing to be negative, while the power house of China has experienced further slippage of late. The latter will have implications for the Australian economy, particularly in respect to the demand for minerals and could, in turn, affect the NZ economy given this country's strong trading relationship with Australia.

Second, while international commodity pressures overall remain under wraps, basically as a result of subdued demand, there are pockets of risk. These relate to the cost of inputs, for example, oil price pressures largely as a result of instability rather than demand pressures, with food prices likely to come under pressure as costs such as grain prices rise as a result of droughts. However, importantly, food prices do not necessarily relate one-for-one in terms of commodity prices, as many factors affect the cost of food such as energy, transport, packaging and so on.

Third, high levels of household and farm debt are undermining people's confidence to spend with both businesses and households instead keenly focused on reducing debt levels. This is no bad thing but does affect domestic consumption as indicated by relatively subdued retail and electronic sales data.

Fourth, the net outflow of permanent and long-term migrants is a significant issue for NZ, particularly in terms of loss of skills to Australia. This will put pressure on the ability of NZ to supply the number of skilled workers required for the rebuild of Christchurch.

Fifth, the cost of capital and investment risk to NZ if the issue of property rights to natural resources such as freshwater cannot be sorted out speedily in a transparent manner, allowing both domestic and international investors to proceed with a reasonable degree of certainty. As has been said many times, markets dislike risk and will build in appropriate rate of return buffers to deal with uncertainty, or alternatively, in the worst case scenario, will not invest in NZ at all but move to more hospitable investment regimes where property rights are more transparent and secure.

Given all the potential associated with the above comments, 2.5 to 3 percent forecast growth out to 2014 doesn't sound too bad. We'll take it.

1.2 Monetary Conditions – global monetary policy conditions impacting on NZ

Interest rates – no change

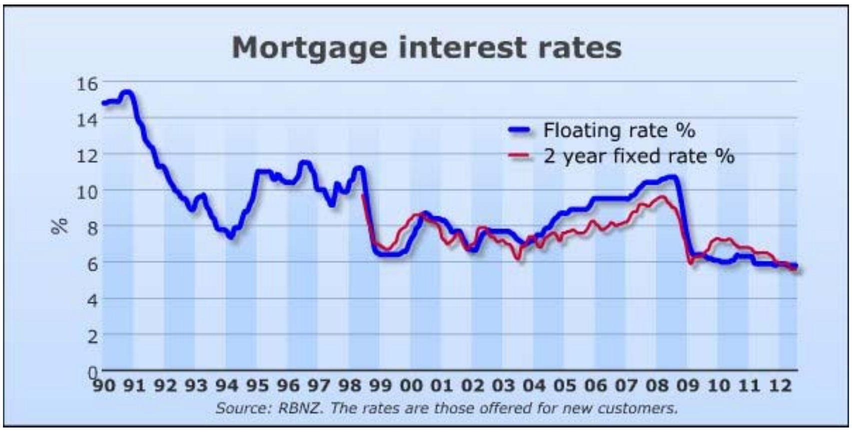
The 90-day bill rate is forecast to increase slowly and reach 3.4 percent by September 2013 and 4.3 percent by September 2014, as evidenced in the forecasts below.

Forecasts: Interest Rates (90 day bills)

	As at end of		
	Sep 12	Sep 13	Sep 14
Highest	2.8	3.5	4.8
Average	2.7	3.4	4.3
Lowest	2.7	3.3	3.8

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

With inflationary pressures (and expectations) at historic lows, the likelihood of any interest rate rises in the foreseeable future is very slim. Indeed there is an equally slim chance of an interest rate cut, although the Reserve Bank will be keep something in the tank in case the global economy really terms sour.



As widely expected, the recent Monetary Policy Statement (MPS) from the Reserve Bank (13 September 2012) showed that conditions have not changed markedly since its last statement and as a result, there has been no change in the OCR. Given this was the last statement of the outgoing Governor, Dr Alan Bollard, it was widely expected that the statement would be relatively benign and not likely to hint at any possible OCR change.

The New Zealand Institute of Economic Research (NZIER) Shadow Monetary Policy Board (whose task it is to recommend interest rate settings ahead of each decision by the Governor of the Reserve Bank of NZ) found the majority still supported 'no change' to the Official Cash Rate (OCR): *"Global risks remain. Deteriorating Euro area growth and financial instability are lowering exports in China and elsewhere in Asia. That reduces activity in Australia and makes for a weak trading partner outlook.*

"Domestically the recovery is muted and inflation contained. The Board is highly supportive of leaving interest rates at 2.50% but if there was to be a move, a cut would be more appropriate than a hike."

The New Zealand dollar – volatility will continue on the back of ad hoc adjustments from big economies

Forecasts below show the NZ dollar is likely to be very stable against the Australian dollar, although it is expected to fluctuate much more against the $US.

Forecasts: Exchange Rates

AUD (cents)			
	Sep 12	Sep 13	Sep 14
Highest	0.796	0.806	0.800
Average	0.785	0.796	0.792
Lowest	0.780	0.788	0.789

USD (cents)			
	Sep 12	Sep 13	Sep 14
Highest	0.820	0.850	0.790
Average	0.805	0.820	0.760
Lowest	0.790	0.790	0.710

TWI			
	Sep 12	Sep 13	Sep 14
Highest	74.4	74.4	72.0
Average	72.9	73.4	69.9
Lowest	71.2	71.7	65.1

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

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

A very good paper by the Governor of the Reserve Bank, Alan Bollard *"Learnings from the Global Financial Crisis"* (9 August 2012) provides some useful insights into the crisis and its impact on both monetary and fiscal policy settings: *"The crisis has also challenged us as financial regulators and monetary and fiscal policymakers. We are all working to understand, contain and repair the damage to financial systems, to economies and to governments' financial capacity. The policy choices in many areas involve difficult and uncertain tradeoffs."*

A number of countries (e.g. United States and Britain) have introduced policies such as "quantitative easing" which in essence means increasing the money supply. Essentially a central bank buys financial assets to inject a pre-determined *quantity* of money into the economy. A central bank implements quantitative easing by purchasing financial assets from banks and other private sector businesses with new electronically created money – hence the often-used term, "printing money". Such quantitative easing is usually undertaken as a last resort to stimulate the economy after interest rates have effectively come close to zero.

Such policies can result in a lowering of a country's currency versus that of other countries. However, they are not without risks. There is still debate internationally as to their impact and long-term effects are uncertain.

Quantitative easing can result in higher inflation than desired if the amount of easing required is overestimated and too much money is created. On the other hand, it can fail if banks remain reluctant to lend money to smaller businesses and households, thereby increasing demand. In the context of traditional monetary policy tools, quantitative easing is quite radical and arguably should be used only as a last resort.

Alan Bollard, in the same paper stated: *"Unconventional policies can have unconventional side effects. We are currently observing spillovers from large economy QE impacting capital flows and exchange rate pressures in small open economies. Continuing exchange rate pressure is problematic for a country like New Zealand."*

The Governor's paper clearly indicates that there are no easy options or silver bullets and underlines the importance of examining policy tools and their implications from a wide range of perspectives. The danger in meddling with the Reserve Bank Act (or other Acts in response to short-term problems) needs to be clearly understood. It is important for any new tool to be fit for purpose.

Many of the concerns with exchange rates, volatility etc, are the result of developments and interventions in international markets, rather than any inherent weakness in NZ's monetary policy framework. The danger with trying to adjust policies to reflect international developments and knee-jerk international interventions is that monetary policy becomes more and more murky and risks damaging NZ's long-standing and transparent monetary policy framework. This kind of policy adjustment would have obvious flow-on implications in terms of foreign investment and possibly the cost of capital.

Inflation - subdued expectations

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

Headline inflation is one thing, but perhaps equally important are business and consumer expectations about future inflationary pressures. Clearly, surveys would suggest that inflationary pressures are low, probably for a range of reasons.

First, a relatively subdued global economic outlook is taking pressure off resources – although as stated earlier, this could change, particularly in respect to food and oil.

Second, strong competition in the domestic market has resulted in profit margins being slashed with many businesses relying on heavy discounting in order to make sales. Retail prices slashed by up to 60 percent are not unheard of.

Third, net migration outflows will take further pressure off resources, including housing, although over the longer term they could impact adversely on the quality and size of the labour market – particularly in terms of increasing demand for skilled trades people as the Christchurch rebuild gains momentum.

On the other hand, there will be some potentially upward pressures on prices e.g. the increasing cost of insurance as a result of the Christchurch earthquakes and a general re-pricing of insurance risk. And new building standards, also driven largely by the Christchurch earthquakes, could add substantially to building costs.

Just because current inflationary expectations are relatively subdued, New Zealanders, including the Government, should not have a false sense of security. In some sectors, including the non-tradables sector, inflationary pressures still exist. Local Government rates are a good example.

Government needs to be constantly on the ball in terms of looking at any regulatory barriers to increasing competition and ensuring costs are contained, particularly in those areas where consumers have little choice as to what services they pay for. On this point, the Government's proposals contained in the Local Government Act 2002 Amendment Bill (currently before a Parliamentary Select Committee) which is targeted, amongst other things, at getting local Government to focus on the provision of core services, is a very welcome initiative.

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Sep 12	Sep 13	Sep 14
Highest	1.3	2.6	3.3
Average	1.1	2.3	2.7
Lowest	1.0	2.1	2.4

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

1.3 Business and consumer confidence – on right side of the ledger

Business confidence – mixed results

A number of surveys show business confidence is still on the positive side of the ledger although there appears to be a disconnect between business confidence on the one hand and the willingness to invest on the other.

The National Bank's Business Outlook (August 2012) shows a net 20 percent of businesses expecting better times for the economy over the coming year, up from a net 15 percent a month ago.

Firms remain relatively positive about their own activity outlook with a net 26 percent of respondents expecting an improvement, in line with the survey's long-run average.

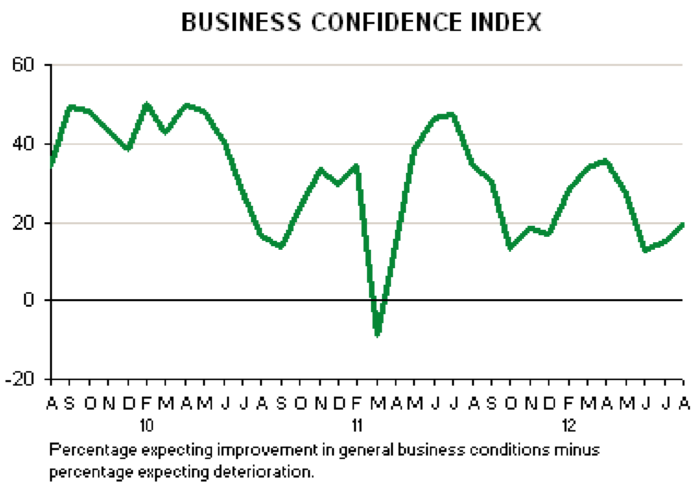
Other survey results provide a similarly ho hum picture and this is being reflected in official statistics.

Profit expectations are marginally in positive territory.

A net 6 percent expect to hire more people over the coming year (down from a net 11 percent last month).

Investment intentions eased slightly to a net 11 percent, down 2 on the previous month.

National Bank Business Confidence Index



On the positive side, export intentions picked up, albeit from a relatively low base, while residential investment intentions bounced back, with confidence particularly strong in Auckland.

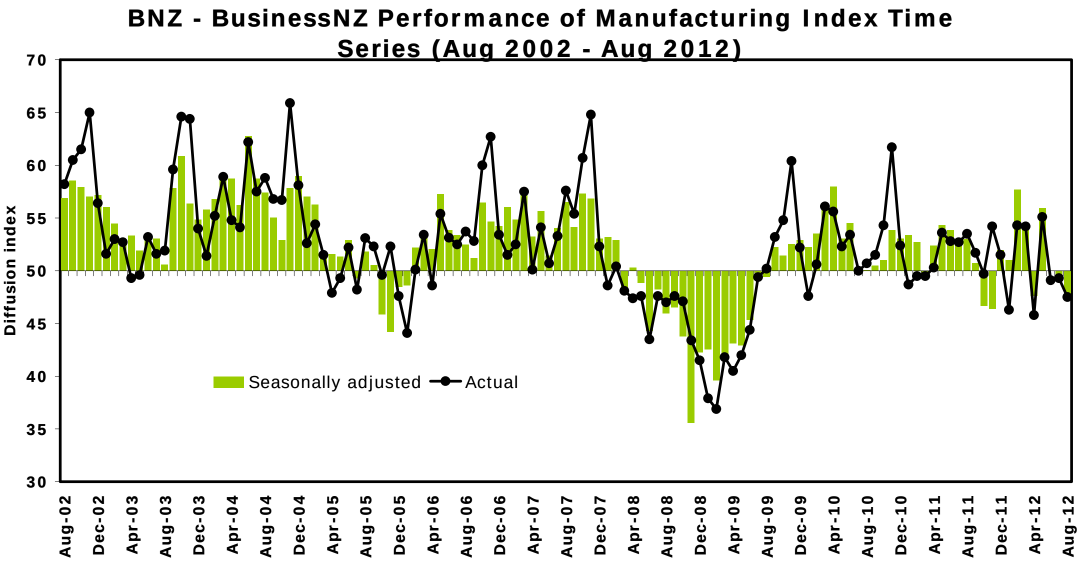
Consistent with other surveys, pricing intentions remain sombre while inflation expectations are the lowest since 1999.

Overall, it is hard not to conclude that the economy is basically treading water – neither sinking nor showing strong forward progress.

Other indicators of business confidence show mixed results although generally are consistent with the subdued theme.

The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) started the 2012 year with a hiss and a roar but as time has gone on, the wheels have tended to slow. In fact, the latest reading (August 2012) shows a negative result with the PMI sitting at 47.2, 2.2 points down from July and the lowest overall result since November 2011. Compared with previous August results, the 2012 value was the lowest since 2008.

A PMI reading above 50 points indicates manufacturing activity is expanding; below 50 indicates it is contracting.

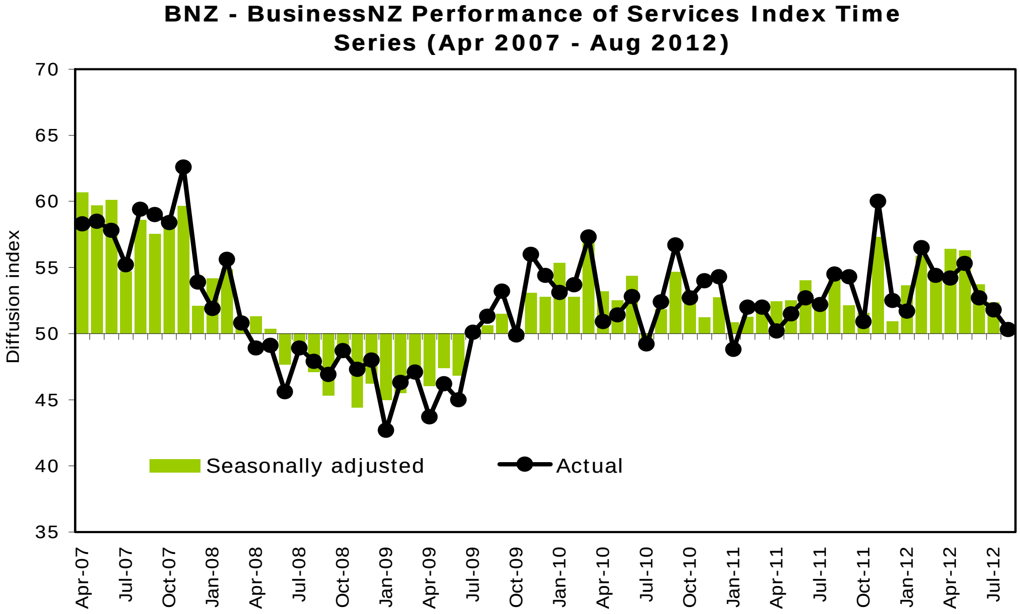


Source: BusinessNZ

All five seasonally-adjusted main diffusion indices were in contraction in August, the first time this has occurred since October 2011. The worst result was for *employment* (45.4), which fell 2.1 points from July and the lowest result since July 2009. This was followed by *production* (47.6), which fell 1.9 points. The remaining sub-indices were in a very tight band of activity, with *new orders* and *deliveries* both on 48.1, while *finished stocks* (48.0) was the only sub-index to improve, rising 0.4 points from July.

The seasonally adjusted BNZ-BusinessNZ Performance of Services Index (PSI) for August 2012 was bang on 50.0 i.e. neither in expansion mode nor in contraction. This was down 2.4 points from July, the fourth consecutive fall in expansion. Compared with previous August results, the 2012 value was the second lowest recorded since 2007.

Looking more in-depth at the August PSI result, although the result overall showed no change, there was a considerable difference evident within the five sub-indices for August. *New orders/business* (55.4) again led the charge, although at its lowest point since December 2011. *Activity/sales* (51.0) slipped another 0.8 points, while *stocks/inventories* (51.8) increased 0.5 points from July. *Supplier deliveries* (46.6) continued its trend downwards, while *employment* (46.5) experienced the largest drop of 5.8 points from July to be at its lowest point since June 2009.



Source: BusinessNZ

Other sectors remain mixed. Optimism in the agricultural sector has taken a dive as evidenced in Federated Farmers mid-year Farm Confidence Survey. Although the survey indicated that confidence had dropped sharply, this needs to be taken in context. *"The 2011/12 season was probably one of the best in recent history for dairy, meat and wool, Farmgate prices were high and the weather, for the most part, was kind to production. There was always going to be a drop in the survey indicators*."

The headline results from the Farm Confidence Survey show that a net 38.7 percent of respondents expect general economic conditions to worsen over the next 12 months while a net 39.5 percent expect their own farm's profitability to worsen over the next 12 months

Notwithstanding this significant drop in confidence, a significant number of respondents expect production to increase while continuing the retire debt.

The retail sector is showing some mild growth of late, but off a relatively low base.

On a brighter note, construction is starting to gear up with the rebuild of Christchurch encouraging a shift of resources to that region. House prices are starting to lift, particularly in Auckland, as population growth continues to assist new house builds.

Consumer confidence – cautious

Consumer confidence remains in positive territory but results show an underlying theme of continuing caution with a strong focus on debt reduction and wallets tucked firmly away.

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

While retail sales and electronic transactions have shown some lift of late, this is off a reasonably low base.

Consumers and households are still heavily focused on retiring debt. Debt reduction is being assisted by historically low interest rates with little chance of interest rate hikes given a general lowering of inflationary expectations.

1.4 Labour market – meandering

Employment – drifting upwards slowly

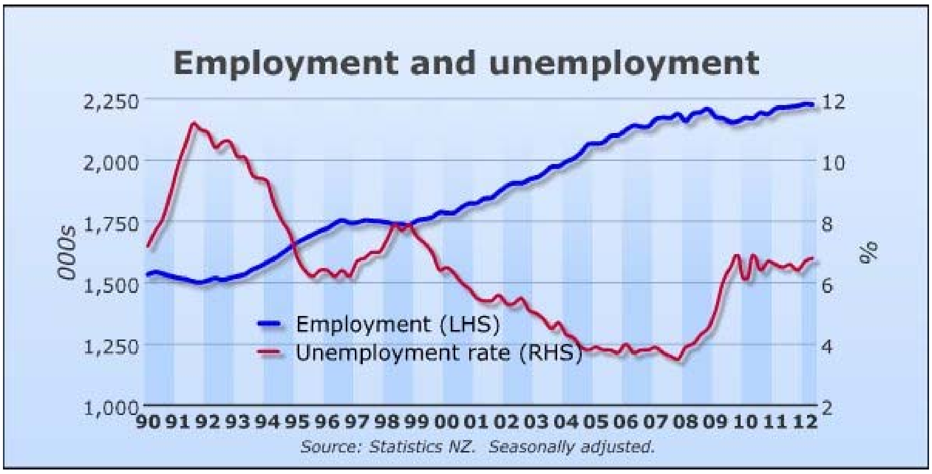
Forecasts show that unemployment is expected to drift lower over the next 2 years to reach 5.4 percent by September 2014. This might be a tough ask if current official and unofficial data are anything to go by.

Forecasts: Unemployment % (HLFS)

	Quarter		
	Sep 12	Sep 13	Sep 14
Highest	6.7	6.3	6.0
Average	6.5	5.9	5.4
Lowest	6.4	5.4	4.5

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

Official data show that over the past year to 18 months, both employment and unemployment have more or less remained at similar levels with no marked increase in either.



The latest BNZ-BusinessNZ PMI and PSI (mentioned above) show that employment in both the manufacturing and services sectors has taken a dive over the last month. While not too much should be read into the results of a month or even a quarter for that matter, the relatively stagnant position of aggregate labour market data is also consistent with forward looking data.

Certainly, there are now pockets of optimism in some regions, Christchurch being the obvious example. However, forward looking data, e.g. the ANZ job ads series, which collects newspaper and internet job ads, continues its flat trend since mid-2009.

Labour costs – subdued overall

Forecasts below indicate that labour costs are expected to increase slowly to around 2.4 percent for the year ending September 2014. This is very much in line with the long-run average for the Labour Cost Index and up slightly on recent annual increases which have averaged around 2 percent. Forecasts largely reflect the slight pick up expected in labour market outcomes predicted over the medium term.

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

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

	Years ending		
	Sep 12	Sep 13	Sep 14
Highest	2.0	2.6	2.8
Average	1.9	2.0	2.4
Lowest	1.9	1.5	2.2

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