BUSINESS NZ

PLANNING FORECAST

MARCH 2019

BusinessNZ

NZ Economy: cross-currents of risk

Executive Summary

Management of risk is currently the name of the game with a particular focus on the international economy. The international economy faces a number of ongoing risks likely to impact on NZ's domestic economy while as well, certain domestic risks will hinder plain sailing over the next year or two.

On the international front, the key issues are trade-related. The ongoing Brexit saga will affect international growth, even though NZ, compared with decades ago, when Britain took nearly all the country's agricultural produce, has considerably expanded its export markets.

In the US, the prolonged and contentious trade dispute with China continues with no certainty of when, or even if, a breakthrough will be achieved. Several false starts have been reported but with no concrete evidence a deal is imminent or necessarily what any deal would entail.

Some reputable international agencies have revised down their global growth outlook. The Organisation for Economic Cooperation and Development (OECD) trimmed the growth outlook for most G20 countries in its Interim Economic Outlook.

On the domestic front, key indicators continue to track at satisfactory levels and point to solid economic growth over the forecast period. However, some issues are causing the broader business community angst and as a consequence, business confidence remains downbeat – despite some variations over the last few months.

Among the issues of concern - expanded upon below - are the potential for a Capital Gains Tax (CGT), the possibility of regulatory overkill in respect to the Reserve Bank's proposals to crank up bank capital requirements (which will simply lead to a higher cost of capital to small businesses and homeowners, particularly problematic given high levels of both household and agricultural debt in particular), and the continuing difficulty of recruiting skilled (and unskilled) workers in key areas to supplement NZ 's existing labour force. Changes to educational structures, including to the role of polytechnics and Industry Training Organisations (ITOs) in NZ are also giving some in the wider business community cause for alarm.

Throw into the mix the potential for a wide range of labour market changes and it is not surprising businesses are feeling a little under the pump at present.

But despite all the above factors, positives are apparent as the Government heads towards the opening of the books on Budget Day, 30 May. The Government's fiscal position is still relatively sound, although the potential risk from (particularly) natural disasters is something both central government and local government will need to be mindful of for the future. In this respect it is timely the NZ Productivity Commission (at the Government's request) has produced an Issues Paper on Local Government Funding and Financing given current rating policies, are largely no longer fit for purpose.

Management of risk is an issue which both central and local government, businesses and households need to build into future thinking otherwise knee-jerk (and costly) reactions will inevitably be the order of the day.

HIGHLIGHTS

The NZ economy is forecast to grow, on average, at just under 3 percent out to March 2021.

The BusinessNZ Economic Conditions Index (a measure of NZ's major economic indicators) sits at 8 for the March 2019 quarter, up 6 on the previous quarter and up 2 on a year ago.

The BNZ - BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the Performance of Services Index (PSI), continue to show satisfactory levels of expansion going into the March quarter 2019.

Key economic indicators continue to provide a relatively positive story in regard to employment, unemployment, inflation, and interest rates. On the other hand, debt levels remain a concern.

Some sectors are feeling under the pump with potentially added regulatory costs and uncertainty holding business confidence down. Consumer sentiment has also generally slipped of late to currently sit around its long-term average.

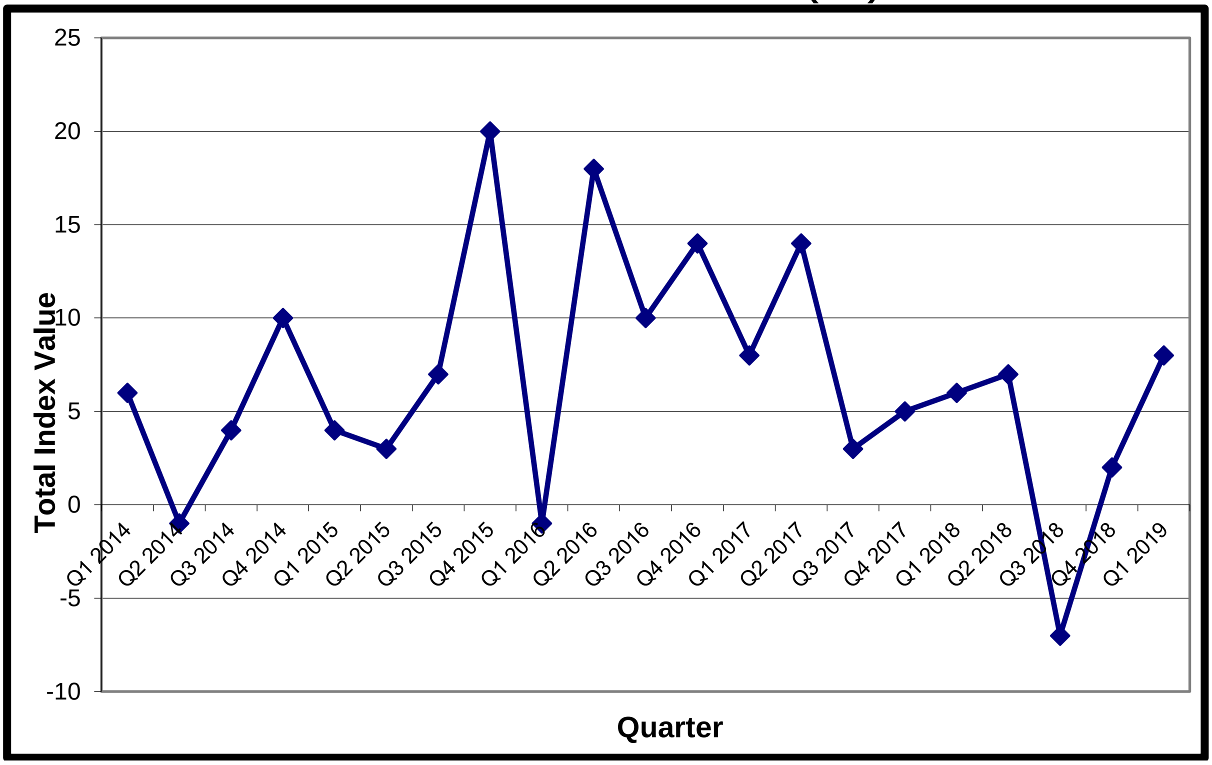
At the international level, projected growth rates have eased slightly on the back of inconsistent and ad hoc policy decisions. Uncertainty about Brexit and the on-again off-again threats of trade wars, particularly between the US and China, have caused some jitters in financial markets. Notwithstanding such risks, global stockmarkets have generally weathered the storm, with key markets at or close to where they were before a rapid sell off over the fourth quarter of 2018.

PART 1: THE NZ ECONOMY – WHERE ARE WE NOW?

BusinessNZ Economic Conditions Index (ECI)

The overall BusinessNZ Economic Conditions Index (a measure of NZ's major economic indicators) sits at 8 for the March 2019 quarter, up 6 on the previous quarter and up 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

Of the ECI sub-groups:

Economic growth/performance indicators sit at 3 for the March 2019 quarter, up 2 on the previous quarter and up 2 on a year ago. New Zealand's terms of trade (a measure of the purchasing power of its exports and a key indicator of the economy overall) are still solid, backed up by an improving outlook for dairy.

Monetary policy/pricing indicators sit at 2 for the March 2019 quarter, up 6 on the previous quarter and up 2 on a year ago. A rising NZ dollar has kept tradeables' inflation well under control, although the non-tradeables sector has shown some uplift of late. Overall, no change in monetary policy settings is currently required.

Business/consumer confidence indicators sit at 3 for the March 2019 quarter, down 2 on the previous quarter and down 1 on a year ago. Business confidence indicators have largely remained in the doldrums since the third quarter of last year. Some sectors face ongoing concerns about regulatory risks. While consumer confidence remains relatively robust, it has also slipped of late to sit currently around its long-term average.

Labour market indicators sit at 0 for the March 2019 quarter the same as for the previous quarter and down 1 on a year ago. Reasonable employment growth, lower net migration inflows, and unemployment currently hovering just over 4 percent are causing significant stress for businesses trying to source both skilled, and to some extent unskilled, labour.

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[1] The ECI tracks over 30 indicators on a quarterly basis. The overall index value for any particular quarter represents the net balance of the indicators (generally the number increasing minus the number decreasing) thus providing an overall measure of performance. The results for the March quarter 2019 are estimates based on available information to date.

PART 2: THE NZ ECONOMY – WHERE ARE WE HEADING

1.1 Economic growth (GDP) – easing

Forecasts out to March 2021 show the NZ economy continuing to grow at a satisfactory rate at just below 3 percent per annum, although some softening is expected as a result of heightened risks, some of which are identified below.

At present, the only real certainty is the uncertainty prevailing both internationally and domestically. Businesses, and indeed households, must increasingly manage several risk factors which in the past would have been considered one-offs or would not have fallen within the realm of rational possibility. The recent horrific event in Christchurch, in which 50 people were killed, being an example of this.

Dealing with the international scene first.

Some reputable international agencies have downgraded the outlook for the global economy for both 2019 and 2020.

The OECD, in its latest Interim Economic Outlook, has revised downwards its forecast outlook for growth across almost all G20 countries, with particularly large revisions in the euro area for both 2019 and 2020, driven by weakness in Germany and Italy, but also in the UK, Canada and Turkey. The OECD points to the manufacturing sector as taking a hit across the G20 on the back of trade tensions. (See graph below for latest international results in respect to the Performance of Manufacturing Index (PMI)). Note a PMI result above 50.0 indicates that the manufacturing sector is generally expanding; below 50.0 that it is declining).

On the other hand, the OECD sees some supporting factors for continued growth, including easier financial conditions, with major central banks having signalled a pause in moves towards more "normal" monetary policy settings.

Three major sources of risk identified by the OECD include:

- Trade Policy
- China's slowdown
- EU trade linkages and Brexit

Regarding trade policy uncertainty, the OECD considers this will remain a significant drag on global investment, jobs and, ultimately living standards. It is thought that even if the US and China conclude a trade agreement soon, there is no guarantee other measures won't see new restrictions in trade-sensitive sectors which will obviously have flow-on implications for supply chains.

The second factor identified is the ongoing uncertainty as to the extent of China's slowdown. While the Chinese government has engaged in a sizable monetary and fiscal policy stimulus, including tax cuts and infrastructure investment, the jury is still out as to how effective this move will be. Given NZ's reliance on China as our biggest trading partner, the outlook for China (and our second biggest trading partner Australia) is crucially important to NZ's well-being. Between them, China and Australia account for around 40 per cent of NZ's trade. It is in NZ's interest for our key trading partners to be doing well.

Third, the OECD has identified trade linkages as also being crucially important since goods and services are often produced across several countries. Brexit is identified as an immediate downside risk with growth rates in the UK already taking a hit. As has been said many times, markets do not like uncertainty which may encourage both labour and capital flight until the rules of the game are clearly laid out for investors.

While uncertainty over Brexit is unresolved, it is likely to have a relatively small impact on NZ. Trade with the UK is reasonably small (around 3 percent of NZ's total trade) and some goods can probably be diverted to other markets. The more crucial issues are likely to be short-term, such as dealing with potential disruption at the border.

Despite these risk factors, international commodity prices are fairly positive. Dairy prices are looking up as the European Union stockpiles recede. Fonterra has raised its forecast farmgate milk price to between $6.30 - $6.60 per kg.

On the domestic scene, downside risks have been heightening of late:

- Management of risk is something both central and local government, businesses and households need to build into future thinking otherwise knee-jerk (and costly) reactions are likely to be the order of the day. A broad range of issues is involved from climate change through to earthquake strengthening and minimising the risks associated with terrorism.
- The impact of significant changes to labour market legislation (including significant rises in the minimum wage) which could adversely affect both business costs and the ability of low-skilled persons to enter the labour market and improve their earnings potential over time.
- Continued concerns remain over the ability to recruit skilled (and unskilled) workers in key areas to supplement NZ 's existing labour force. Changes in educational structures, including the role of polytechnics and ITOs in NZ, are also giving cause for alarm amid the wider business community.
- The impact of proposed changes by the Reserve Bank in respect to the Capital Adequacy of banks which could adversely impact on the cost of capital. This is a crucial issue as NZ has high levels of both household and agricultural debt.
- Potential changes to the taxation regime, including the effect of the move to expand the taxation of capital gains and its impact on particular sectors and on incentives/disincentives to invest.
- Fall-out, particularly in respect to tourism as a result of the recent horrific killings in Christchurch.
- The longer-term impact of Mycoplasma Bovis on agricultural production and capital stock numbers.
- The effect of weather conditions (particularly drought) on agricultural production.
- Capacity constraints, not only in relation to natural resources (e.g. water) but wider constraints on labour supply.
- Transition costs associated with moving towards a zero-net carbon emission economy by 2050.

Some sectors will be more affected by the above risks than others and some risks may be more short-term than long-term. However, heightened uncertainty is a risk which will be factored into markets (including pricing structures and interest rates) and is likely to impact adversely on NZ's growth rate over the next few years. This means it is crucial policy decisions are soundly based and do not needlessly raise business costs, limiting the ability of NZ to compete internationally.

Despite all the risk factors identified above, there are certain positives heading into the opening of the government's books on Budget Day, 30 May. The country's fiscal position remains relatively sound with Standard and Poor's revising the outlook on NZ sovereign long-term credit rating up to positive from stable.

Notwithstanding NZ's sound fiscal position, backed up by a credible and transparent Public Finance Act, there are the potential risks of (particularly) natural disasters, something both central government and local government need to be mindful of in the future. In this respect, it is timely the NZ Productivity Commission (at the Government's request) has produced an Issues Paper on Local Government Funding and Financing, current rating policies being largely no longer fit for purpose.

Forecasts: Real GDP percent Growth

	Years Ending		
	Mar 19	Mar 20	Mar 21
Highest	2.7	3.3	3.0
Average	2.6	2.9	2.7
Lowest	2.6	2.6	2.5

Source: ASB, BNZ and Westpac

1.2 Monetary Policy – no justification for proposed changes

The Reserve Bank (assisted by the Treasury in some cases) has been active in issuing a number of consultation documents ranging from significant issues such as *"Safeguarding the future of our financial system"* to a more recent one entitled *"Capital Review Paper 4: How much capital is enough".*

The danger is such papers are often given only a cursory glance by the public before being cast aside as merely some kind of academic exercise.

Nevertheless, the implications of such consultation papers for everyday householders and businesses deserve serious thought, particularly as they may mean increases in the cost of credit for both at a time when debt levels are historically high.

Some background on the papers.

The Consultation Paper *"Safeguarding the future of our financial system"* focuses on five key issues:

- Objectives: What high-level financial objectives should the Reserve Bank have?
- Regulatory Perimeter: What financial firms should the Reserve Bank regulate and how should the regulatory perimeter be set?
- Depositor Protection: Should there be depositor protection in New Zealand?
- Separation: Should the regulation of financial firms remain with the Reserve Bank?
- Governance: How should the Reserve Bank be governed, including who should make the Reserve Bank's decisions?

It is entirely appropriate for the Reserve Bank to look seriously at the soundness of its current prudential management systems to see if anything more can be done to manage risk successfully. But in doing so it should keep in mind there is an optimal amount of resource to be used in reducing risk, given risk cannot be completely eliminated or if at all, not without great cost.

The Consultation Paper outlines potential reasons for protecting depositors as well as some of the risks associated with same. The pros and cons are clearly outlined and so are not repeated here; suffice it to say BusinessNZ considers the risks to be potentially significant, particularly if protection for bank depositors opens the flood-gates to requests for protection from all other kinds of investments that happen to go wrong. In short, where do the boundaries start and end?

The Government needs to be aware that requiring compulsory depositor insurance (protection) will mean it must explain why a great many other compulsory insurance obligations are not also imposed on individuals and households. Picking mandatory depositor insurance out from a host of other so-called issues perceived as deserving is unlikely to sit well with the NZ public, quite apart from sending a signal that implicitly (if not explicitly) government is there to bail out anyone whose finances are affected by an adverse event.

The second Consultation Paper *"Capital Review Paper 4: How much capital is enough"* could well be described as regulatory overkill. The paper proposes significantly greater capital requirements on banks to reduce the risks associated with the potential for a 1 in 200-year bank collapse!

The rationale for the changes is summarized on p.5 of the Review Paper: *"The Reserve Bank is proposing this change to reduce the chances of banks failing in New Zealand. If banks in New Zealand fail, some of us might lose money and some of us might lose jobs. However, there would also be indirect costs on all society that may be harder to see that would negatively impact the well-being of all New Zealanders. In the end, we would bear the cost of bank failures, in one way or another."*

Given the Reserve Bank's recent discussion document on other significant issues, e.g. the proposal for mandatory depositors' insurance, care must be taken that in total, such actions do not in fact lead to regulatory overkill. That could simply add to the cost of capital and/or reduce returns to depositors while potentially reducing the credit available both to smaller business and to particular sectors of the economy (outlined below).

The Review Paper proposes the doubling of banks' minimum "high quality" capital requirements in order to lower the risk of bank failure to once every 200 years. As most banks at present carry significantly more capital than the minimum level government currently requires, a doubling of existing capital held would not be needed. The Review Paper suggests, however, overall capital requirements would have to increase between 20 percent and 60 percent; this would represent about 70 percent of the banking sector's expected profits over a five-year transition period.

While the Review Paper indicates the proposal to increase capital requirements significantly is targeted at minimising the risk of bank failure to a 1 in 200-year event, nowhere is there any detailed evaluation of the proposal's costs and benefits. Why 1-in-200 years? Why not 1-in-1000, or 1-in-10?

The Swiss investment bank UBS has published a research paper outlining the possible impact on consumers of what is proposed, particularly the increased cost of capital. According to UBS, the proposals could add between 80 and 125 basis points to mortgage costs as banks attempt to claw back the added capital costs.

Moreover, the UBS study estimates the proposals would see NZ overtake Norway in having the highest bank capital requirements in the developed world.

While the Reserve Bank has been keen to promote the argument that borrowing costs might actually be lower and returns on capital might not need to be so high if investors have confidence their investment is very secure, it is noteworthy that at least 2 credible international credit rating agencies have questioned whether in fact this would be the case if capital requirements were increased.

Standard & Poor's has calculated that increased capital requirements by themselves will not impact on the four "big" banks' credit rating. And if their credit ratings are not lifted, it appears unlikely they will get the cheaper credit the Reserve Bank appears to suggest.

In December 2018, Fitch Ratings said the proposals were "radical" and "highly conservative relative to international peers" but that the result would ultimately be "significantly stronger buffers" against system shocks.

The potential impact on capital markets of raising the required capital could be significant when $15-$20 billion is likely involved. This amount of capital raising in not insignificant and as in reality New Zealand is not a capital rich country, the additional capital would likely have to come from offshore. Given economies of scale and the smallness of the NZ economy by international standards, it is also likely a risk premium would be involved. And while it is accepted the Reserve Bank proposes a phased-in approach over 5 years, the potential impact on capital raising should not be underestimated. To put this in context, the total capitalisation of the NZ sharemarket is only around $150 billion.

The distributional and equity effects would likely have an added impact on the NZ economy in view of households' relatively high net debt and particularly agricultural sector debt. Household debt levels are currently in excess 160 percent of disposable income (compared with around 100 percent in 2000). Meanwhile. agricultural debt has continued to ratchet up and is currently sitting at around $63 billion (up from $12 billion in 2000), with around two-thirds of debt focused on the dairy sector.

Any significant change in interest rates could be enough to tip households and businesses over the edge with flow-on effects for creditors and the economy in general through reduced levels of activity.

A 100 basis point increase in interest payments on household debt would add about $2.6 billion on annual interest rates costs facing households, while a 50 basis points increase would add about $1.3 billion to interest costs. In respect to the agricultural sector, a 100 basis point increase in interest rates would add around $630 million in interest costs while a 100 basis point increase in business debt would add in excess of $1 billion to interest costs.

With the significance of the agricultural sector to the NZ economy (compared with most developed countries), it is important restrictions on lending to the sector and/or increasing the cost of capital do not put added pressure on specific sectors, the more so in light of the current uncertainty of international trading arrangements.

Many small business owners use housing mortgage finance to partially fund business activities. They may do this for a variety of reasons including, but not limited to, the fact that housing mortgage finance is generally less costly than business finance. By in effect limiting this source of finance, the ability for many small business ventures to get off the ground could be unnecessarily restricted.

Considering the points raised above, BusinessNZ does not support any increase in bank capital requirements. However there could be merit in providing individuals and businesses with greater information about the risks of investing, potential returns and the need to ensure the use of adequate risk management techniques to minimise the possibility of significant failure. The information campaign should not be directed only to bank depositor risk but also to risk generally, particularly as it appears many individuals are not fully informed of the benefits and costs associated with property or health insurance or the many other risks they, and businesses, face daily.

Interest Rates – locked down

The 90-day bill rate is forecast to edge up slightly by March 2021 (see forecasts below).

At its latest review, the Reserve Bank, as widely predicted given some current uncertainty both nationally and internationally, kept the OCR at 1.75 percent, although the Reserve Bank stated that given the weaker economic outlook and reduced momentum in domestic spending, the more likely direction of the next OCR move is down. In our view, there is little pressure at this stage to lift (or lower) the rate, certainly the majority – but not unanimous – view of the Institute of Economic Research's (NZIER's) Shadow Policy Board at its most recent review.

There are a couple of reasons why the Reserve Bank may now be more cautious about making any movement on interest rates (either up or down). First, the Bank now has a dual mandate enshrined in the Reserve Bank Act - to take into account both price stability and maximum sustainable employment. These dual objectives are likely to make interest rate decision-making more complex than in the past, at least on the margins. The addition of a monetary policy committee could also add to this complexity.

Second, the potential for the introduction of greater bank capital requirements, as mentioned earlier, could see interest rates rise for households and businesses. It is therefore possible the Reserve Bank will need some scope to lower the OCR in response, if, as expected, such a policy, resulted in upward pressure on interest rates.

It is possible the Reserve Bank could lower the Official Cash Rate (OCR) in an attempt to compensate for any impact a mandatory capital requirement increase might have on mortgage interest rates. But it would call into question the rationale for greater capital requirements if the immediate effect were to increase mortgage interest rates. Such matters would need to be considered as part of the cost-benefit analysis BusinessNZ recommends the Reserve Bank undertake before deciding on any substantial increase in banks' minimum capital requirements.

Further, with the OCR currently sitting at 1.75 percent, there is no real room for any significant reduction as the Reserve Bank must recognise the need to leave a little in the tank (i.e. ability to reduce the OCR) should the NZ (or world economy) face a significant downturn.

At the international level, uncertainty over moves towards greater normalisation of monetary policy settings has halted interest rate rises, including more recently, in the US. The European Central Bank (ECB) has acknowledged recent weakness in European data and has put any intention to increase interest rates on hold. Ongoing trade tensions, uncertainty over Brexit and geopolitical tensions mean there is still the potential to derail what at present are relatively strong growth prospects internationally, likely tempering any future rise in international interest rates.

Forecasts: Interest Rates (90-day bills)

	Years ending		
	Mar 19	Mar 20	Mar 21
Highest	1.9	2.0	2.5
Average	1.9	2.0	2.2
Lowest	1.9	1.9	1.9

Source: ASB, BNZ and Westpac

The NZ dollar – in the zone

The NZ dollar has tended to trend up slightly against our major trading partners of late, probably as a result of the NZ economy's reasonably positive outlook together with a reduction in the growth prospects of some of the key players in the world economy and general uncertainty. The US Federal Reserve has recently signalled a delay in any further interest rate rises until 2020, having earlier considered rate rises might be necessary. This too has resulted in a slight increase in the $NZ dollar against the $US.

Notwithstanding this short-term result, on balance, the $NZ is expected to remain relatively stable against both the $Australian and the $US with the Trade-weighted- Index (TWI) expected to drift slightly lower out to March 2021.

But despite current forecasts, the risk of wild swings in exchange rates cannot be ruled out. Particular attention will be focused on international economic developments and any substantial changes in interest rates.

Uncertainty over trade deals and uncertainty in general will affect the currencies of countries such as NZ, largely dependent on commodity-based exports.

However, trying to predict the future value of the NZ dollar or any other currency is a fraught exercise. Some volatility continues to be the name of the game, mainly the result of external factors rather than domestic policies per se.

Forecasts: Exchange Rates

AUD (cents)			
	Mar 19	Mar 20	Mar 21
Highest	0.96	0.96	0.96
Average	0.96	0.95	0.94
Lowest	0.96	0.92	0.92

USD (cents)			
	Mar 19	Mar 20	Mar 21
Highest	0.68	0.70	0.72
Average	0.68	0.69	0.70
Lowest	0.68	0.66	0.66

TWI			
	Mar 19	Mar 20	Mar 21
Highest	74.1	74.8	75.0
Average	74.1	73.3	72.8
Lowest	74.0	72.5	70.3

Source: ASB, BNZ and Westpac

Inflation – steady

Forecasts below show inflation as measured by the Consumers' Price Index (CPI) likely to remain well within the Reserve Bank's target band of 1-3 percent to March 2021.

Annual inflation remained relatively stable at 1.9 percent for the year to December 2018, with a rise in the fortunes of the NZ dollar putting downward pressure on tradeables' (imported) inflation. On the other hand, non-tradeables' inflation is showing some signs of picking up, reflecting still strong growth in housing-related costs.

However, despite the relatively stable inflation outcomes expected over the next couple of years, there are both upward and downward risks to maintaining inflation within the Reserve Bank target band.

On the domestic front, increases to the minimum wage for lower income earners may put some upward pressure on prices although in most industries, both domestic and international, the pressure will either see costs largely absorbed through greater productivity gains or households sourcing materials off-shore.

Insurance costs have increased significantly as reinsurers re-price not only earthquake risk but risks associated with possible events such as the impact of climate change, which might lead to increased flooding in some areas. Also, given NZ's relatively small population but the potential for significant claims costs as a result of natural disasters, there is a risk of some insurers leaving the market completely.

It is important that prices (including the cost of insurance) reflect the actual risk associated with particular activities, whether relating to buildings, infrastructure or the health choices individuals make. Making prices more reflective of risk should at least focus households and businesses on the real costs associated with their behaviour. Nevertheless, it is important not to put undue regulatory constraints on insurers providing cover for the NZ market, the country being very dependent on foreign capital to underwrite its insurance market. The Government (read taxpayer) should not be liable for picking up the costs associated with households' and/or businesses' ill-considered decisions.

There are also potential downside pressures on inflation.

Over recent years, global competition and innovation have enabled the development of better products and services at lower cost. Consequently, the old argument that as demand ratchets up, prices will rise does not necessarily hold good now as it did in the past. Prices over a wide range of products and services are dropping, both in real and nominal terms, a significant shift away from the traditional assumption that generalised inflation is here to stay. Moreover, consumers have much more choice about where they can source their products, including the fact that on-line shopping is now a very fast and efficient method of obtaining goods and services. In short, businesses across a range of sectors will have difficulty in passing on rising costs to consumers in the form of higher prices.

The trending down of net long-term migration, after the record number of people coming into the country over the last few years, is continuing to take pressure off both the housing market and general demand. But the Government's decision to stop foreigners buying property in NZ is likely to have little effect on house prices other than in key areas such as Queenstown and to a lesser extent, Auckland.

Lower net long-term migration inflows will put continued upward pressure on the labour market, with businesses through a range of surveys, still clear about the difficulty of recruiting skilled (and in many case unskilled) employees.

Forecasts: Percent Change in Inflation (CPI)

	Years Ending		
	Mar 19	Mar 20	Mar 21
Highest	1.8	2.3	2.0
Average	1.6	2.1	1.9
Lowest	1.5	2.0	1.8

Source: ASB, BNZ and Westpac

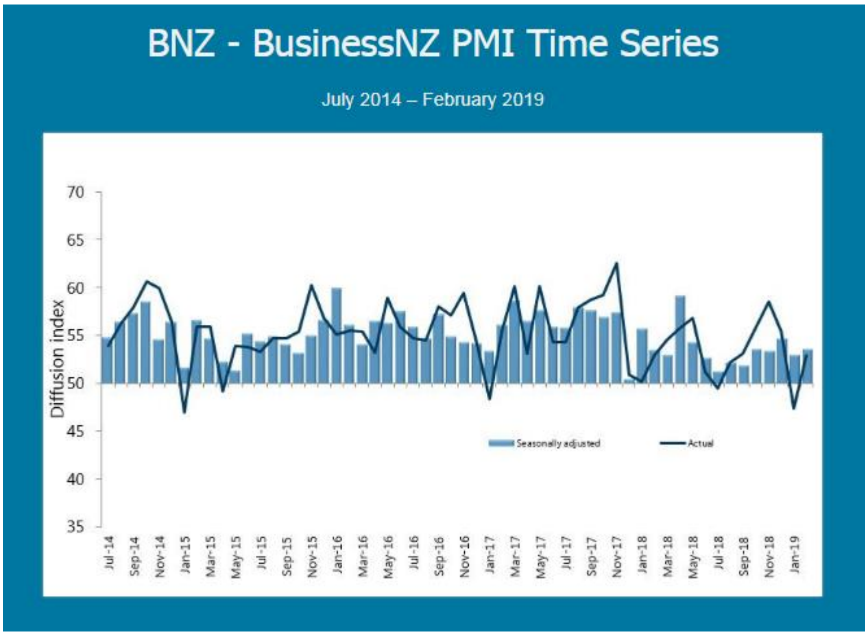
1.3 Business activity and confidence

Business activity and business confidence – slow recovery

Despite business (and consumer) confidence remaining relatively downbeat, a number of key quantitative indicators, such as the latest BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the Performance of Services Index (PSI), still show solid – but not spectacular - growth.

NZ's manufacturing sector experienced a slightly improved level of expansion for February 2019, according to the latest BNZ – BusinessNZ Performance of Manufacturing Index (PMI).

The seasonally-adjusted PMI for February was 53.7 (a PMI reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining). This was 0.7 points up from January and is still slightly above the long-term average for the series.



Looking at the main sub-index value, both production (53.9) and new orders (54.7) showed a part recovery after a noticeable drop in expansion levels during January. However, employment (50.8) dropped a further 1.2 points to its lowest level since August 2018.

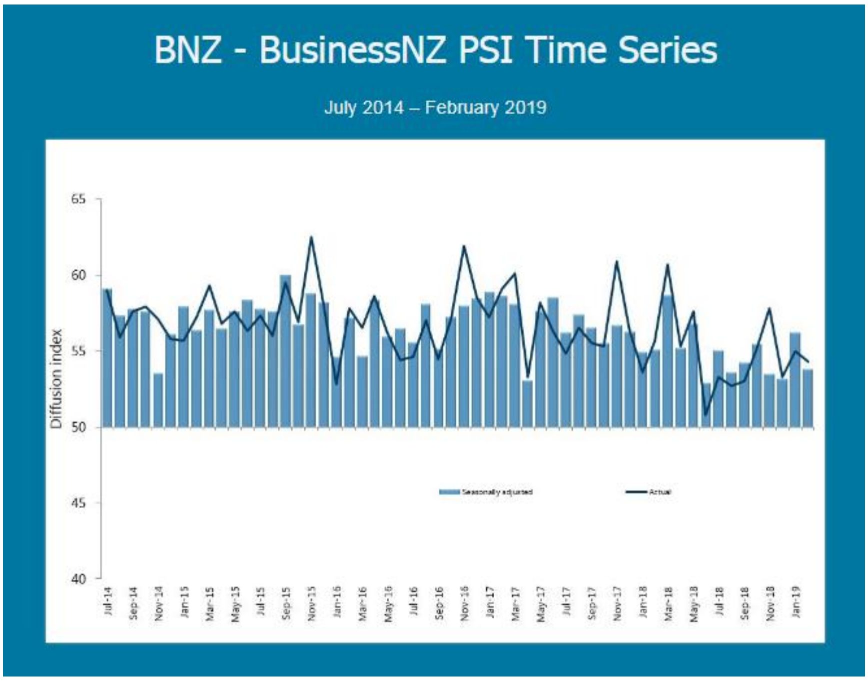
Main Indicies

The slight improvement in February's results also meant the proportion of positive comments for February (51.1%) was up on January (47.7%), but still down from December (60.6%) and November (60.1%). Seasonal factors were evident throughout the comments, although there were respondents who felt that February was business as usual.

While the PMI remains broadly encouraging, inventory dynamics bear watching in case they forewarn of a slower tone to manufacturing production ahead.

In February 2019, NZ's services sector returned to expansion levels experienced in recent months, according to the BNZ – BusinessNZ Performance of Services Index (PSI).

The PSI for February was 53.8, which was 2.4 points down from January (a PSI reading above 50 indicates the services sector is generally expanding: below 50.0 that it is declining). The February result was also below the long-term average of 54.5 for the survey.



While four of the five main sub-indexes showed similar results to previous months, the key sub-index of activity/sales (53.4) decreased 8.1 points. Also, supplier deliveries (49.9) dipped into contraction for February.

Main Indicies

The decrease in overall activity levels also saw the proportion of positive comments in February (52.4%) dip slightly compared with January (54.0%) and December (54.4%). Several negative comments focused on uncertainty in the market, along with slow demand. However, other positive comments outlined new business and a strong demand for certain services.

Overall, the PSI has shown little new direction over the past six months but continues to indicate positive economic growth, albeit a bit slower than that prevailing a year ago.

However, continuing positive results for both the PMI and PSI aside, several business confidence surveys show business confidence remaining at historically low levels.

Business confidence has generally fluctuated of late but remains downbeat with little real uplift since the post-election drop-off last year.

It would be fair to say that given the current amount of policy activity (over a range of issues), businesses are perhaps a little overwhelmed with respect to where things fit, particularly as while some working groups, over a range of issues from taxation policy to employment law, have now reported back (many are still ongoing), the Government has yet to make any substantial policy decisions.

It is crucially important any changes introduced are targeted at improving, rather than acting against, NZ's international competitiveness.

Consumer confidence indicators have also fluctuated a bit of a hit of late. After remaining robust for a number on months, some recent surveys show some slippage probably reinforcing the meandering nature of the BNZ – BusinessNZ Performance of Services Index (PSI) outlined above.

1.4 Labour market – raft of changes in the pipeline

The Government continues apace with labour relations reform through both legislative changes and the establishment of working parties focused on advancing its agenda. A brief summary of some of the key working parties and proposed legislation is outlined below.

Fair Pay Agreements

The Fair Pay Agreement Working Group's report was provided in December and according to the Minister, the Government will now take time to consider its recommendations. These relate to the design of a sector-level bargaining system which would establish minimum terms and conditions for all workers in an industry or occupation.

The Working Group looked at:

- the criteria and process to initiate bargaining on a Fair Pay Agreement
- how bargaining participants will be identified and selected
- what Fair Pay Agreements should cover in terms of scope
- bargaining rules and dispute resolution processes, ratification and enforcement of Fair Pay Agreements

The report can be found at:
https://www.mbie.govt.nz/assets/695e21c9c3/working-group-report.pdf

Holidays Act

The Holidays Act Working Group consultation period closed on 12 October 2018 and a paper setting out options for clear and transparent holiday and leave entitlement rules is to be developed. Thereafter there will be a period when favoured options will be tested.

The Working Group's recommendations must provide for a payroll system that can be readily implemented and accommodate an increasingly diverse range of working and pay arrangements.

The Group is to report back by July 2019. The intention is to proceed slowly with the hope that whatever legislation is developed will be simple and effective.

Equal Pay Amendment Bill

The bill enacts the recommendations of the Joint Working Group on Pay Equity, convened originally by the previous government and again under the current one. The bill gives effect to the Group's recommendations, but also allows the courts to determine backpay, an issue the Joint Working Group had agreed should be left to the negotiating partners. The Minister of Workplace Relations and Safety has admitted this late insertion was a decision taken unilaterally by the Government, being deemed too contentious for the Working Group.

Backpay has serious repercussions for the future of pay equity settlements from the dual perspectives of affordability and consequent sustainability, raising the distinct possibility of deals having to be done incrementally, possibly over years. The Nurses' settlement is a case in point. Nurses had a substantial increase in 2018 in a settlement which includes dealing with pay equity issues this year. The ability to achieve backpay may also make litigation more attractive than bargaining, as the authorities can determine the matter if a claim is stalemated in bargaining. The bill is currently before the Education and Workforce Select Committee with a report back date of 16 April 2019.

Employment – full

Labour market data for the December quarter 2018 was slightly weaker than expected (as measured by the Household Labour Force Survey). According to StatisticsNZ's Household Labour Force Survey (HLFS)), unemployment rose to 4.3 percent.

While care needs to be taken not to read too much into the results for one quarter, it is fair to say the labour market is approaching what could be described as full employment. Indeed, the Reserve Bank in its latest OCR review statement has said that employment is near its maximum sustainable level.

On an annual basis, the total number of people employed rose 2.3 percent with the labour force participation rate currently hovering around 70.9 percent, close to its all-time high.

It is interesting, but not unexpected, that a number of business and research organisations' surveys show the inability to recruit skilled (and in some cases unskilled) labour as now one of the biggest issues affecting business productivity.

Although the unemployment rate is forecast to remain broadly stable at around 4 percent out to March 2021 (see below) there are potential risks to labour market outcomes. These include continuing relatively low levels of business confidence, where both investment and employment intentions have eased, together with the impact of labour market changes with the potential to reduce flexibility and increase business costs, thereby making businesses less competitive.

Notwithstanding a positive overall picture for aggregate employment growth, associated declines in unemployment and a continued, but moderating, growth in job vacancies, significant regional differences remain and perhaps more importantly, differences in various regional areas' unemployment rates. With levels of youth unemployment and young people not in education, employment or training (NEETS) still relatively high, a great deal of effort will be required to ensure the most vulnerable in society are able to participate actively in the labour market.

Forecasts: Unemployment percentage (HLFS)

	Quarter		
	Mar 19	Mar 20	Mar 21
Highest	4.4	4.1	4.1
Average	4.2	4.0	4.0
Lowest	4.1	3.9	3.9

Source: ASB, BNZ and Westpac

Labour costs – growth expected

Forecasts indicate labour costs in general are increasing with a growth rate of just under 3 percent percent per annum by March 2021 (see below).

The Labour Cost Index (LCI) showed moderate growth for the December 2018 quarter, up 0.5% in the quarter supported by the Nurses' collective employment agreement settlement. On an annual basis, the LCI grew 1.9 percent, up slightly on the previous quarter.

Notwithstanding modest increases in wage rates to date, significant increases in the minimum wage over the next couple of years, plus potential pay equity settlements, could have flow-on effects to other areas as employees raise relativity arguments. The Government's proposed regulatory regime for labour markets is also likely to ratchet up labour costs, more so than in the past, given a generalised move towards more centralised bargaining arrangements.

The marked increase in the public sector pay settlement for nurses outlined above, with more to come for the education sector, the police and other areas will not only put added pressure on the government accounts but will add significantly to wage pressures. Watch this space.

The continued slow-down in net migration numbers (although StatsNZ have issued a number of revisions to data based on new collection sources which makes comparisons somewhat fluid), will further constrain the size of the labour market, particularly as labour force participation rates are now close to record levels.

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

	Years ending		
	Mar 19	Mar 20	Mar 21
Highest	2.1	2.6	2.7
Average	2.1	2.6	2.6
Lowest	2.1	2.5	2.5

Source: ASB, BNZ and Westpac