BUSINESS NZ

# PLANNING FORECAST

**SEPTEMBER 2016**

BusinessNZ

## NZ economy – Spring is in the air

**Executive summary**

There is a distinct spring in the step of the NZ economy with nearly all key indicators pointing towards a respectable growth rate of around 3.5 percent per annum, even though a number of issues continue to plague the global economy, including moves towards greater isolationism and protectionist policies.

Both the BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and the Performance of Services Index (PSI) continue to show solid growth and, as evidenced by a range of indicators such as accommodation rates, tourism is now really pumping. The construction industry is going from strength to strength with little sign of any let-up and the agricultural sector, after taking a big hit over the last couple of years with dairy bearing the brunt, has since weathered the storm of low dairy payouts. The agricultural sector now has a positive outlook and a recent Rabobank survey shows farmers' confidence at its highest level since 2013, led by a much more optimistic outlook for dairy.

Forward looking indicators such as the ANZ Truckometer series, which measures heavy traffic, are also producing solid results with outcomes closely correlated to increased economic growth over time. A number of other surveys back up the finding of improved business and consumer confidence in future growth.

The relatively bright outlook across all major sectors is reflected in growing consumer confidence driven by such factors as better employment prospects, relatively low unemployment and low inflation resulting in lower interest rates and hence lower debt servicing costs. These developments support increased expenditure by making households more confident to spend, while relatively strong housing price growth also provides consumers with something of a feel good factor.

But despite a reasonably positive picture, issues remain both domestically and internationally, that could deliver a fly in the ointment.

First, feedback from BusinessNZ's Affiliated Industries Group (AIG) indicates optimism is shared reasonably widely across most sectors, although regulatory issues and uncertainty are still holding some industries back from achieving their full potential.

Second, household and agricultural debt continue to grow at an inflated pace leaving households and farmers vulnerable when the interest rate worm finally turns upwards.

Third, while continuing high levels of inward migration (mainly more NZ citizens returning and fewer leaving) are boosting domestic demand, this puts an added strain on infrastructure, particularly housing.

Fourth, housing costs in NZ relative to income growth have ballooned compared with many other countries, making housing affordability an ongoing issue.

Fifth, NZ's share market has gone from strength to strength, although current levels suggest share prices could be overinflated compared with earnings, possibly leading to a significant future correction – although unlikely to be a significant concern from the point of view of NZ's financial stability. Unlike housing, where substantial debt is involved, banks or other lending institutions are not likely to be exposed in any material way should the share market take a dive.

## *HIGHLIGHTS*

**The BusinessNZ Economic Conditions Index (ECI) sits at 19 for the September 2016 quarter, down 1 on the previous quarter and up 12 on a year ago.**

**The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the BNZ-BusinessNZ Performance of Services Index (PSI) show ongoing consistent expansion. For August 2016 the PMI was 55.1 and the PSI 57.9. (A reading above 50.0 indicates the PMI/PSI generally expanding and below 50.0, declining).**

**All major sectors are showing relatively strong growth with tourism and construction continuing to lead the way. After taking a breather for the last couple of years, confidence has now returned to the agricultural sector, particularly dairy, after recent revised forecasts for the farm-gate milk price along with significant recent gains in Global Dairy Trade auctions.**

**Forward looking indicators of both business and consumer confidence show a positive outlook broadly across the board with consumers opening their wallets more readily than in the past.**

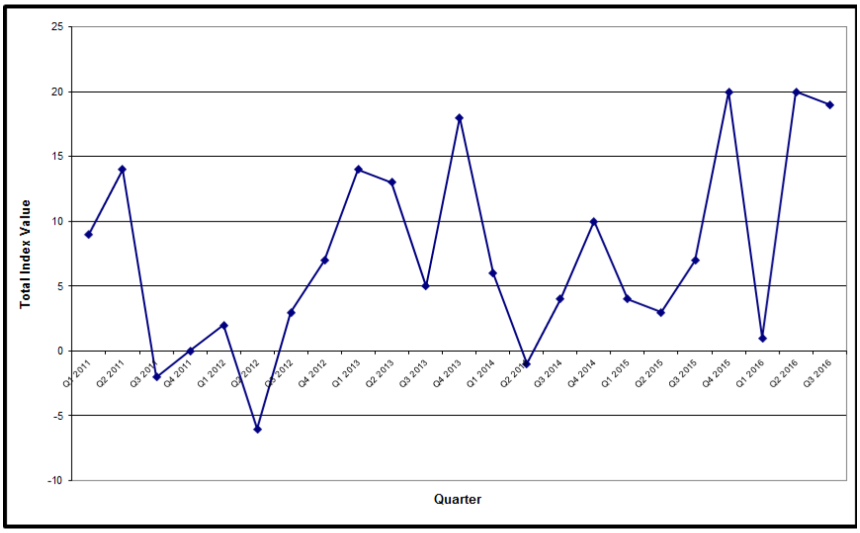
**Despite a generally very positive outlook, risks remain at the domestic and international level. Domestically, these risks include regulatory uncertainty in some sectors, high levels of household and agricultural debt, migration pressures, housing affordability issues, and the potential for a share market correction. At the international level risks include the continued slow-down in China given that (along with Australia) it is NZ's biggest trading partner, ongoing threats of terrorism, post-Brexit jitters, and the danger of more isolationist and protectionist policies stifling international trade.**

## 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 19 for the September 2016 quarter, a decrease of 1 on the previous quarter and up 12 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 5 for the September 2016 quarter**, the same as the previous quarter, and down 2 on a year ago. International commodity prices are starting to rise but returns to exporters have been blunted by a generally rising NZ dollar.

**Monetary policy/pricing indicators sit at 2 for the September 2016 quarter**, down 3 on the previous quarter and down 2 on a year ago. Benign inflationary pressures have seen the Reserve Bank reduce the Official Cash Rate to historically low levels with further reductions likely.

**Business/consumer confidence indicators sit at 7 for the September 2016 quarter**, up 4 on the previous quarter and up 6 on a year ago. Both business and consumer confidence are growing with expectations of reasonably solid growth across all major sectors.

**Labour market indicators sit at 5 for the September 2016 quarter**, down 2 on the previous quarter and up 10 on a year ago. Employment growth remains relatively strong, including in the regions, unemployment is drifting lower, and participation rates are improving on the back of improving job prospects.

[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. 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.

## PART 2: THE NZ ECONOMY – WHERE ARE WE HEADING?

### *1.1 Economic growth (GDP) – 3 percent +*

3 percent + real GDP is forecast for the year to June 2017 before moderating slightly in 2018 (see below). However, reasonably solid growth projections notwithstanding, when calculated on a per capita basis, the rate of growth halves due principally to strong migration inflows pushing up NZ's population.

***Forecasts: Real GDP percent Growth***

| | Years Ending | | |
|---|---|---|---|
| | Sep 16 | Sep 17 | Sep 18 |
| *Highest* | 3.1 | 3.3 | 3.5 |
| *Average* | 3.1 | 3.3 | 2.6 |
| *Lowest* | 3.0 | 3.2 | 2.2 |

*Source: ANZ, ASB, BNZ and Westpac*

The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and the Performance of Services Index (PSI) continue to show solid growth in the mid-50s (a score above 50 indicates expansion – a score below 50 indicates a contraction).

Success in the manufacturing and services sectors is equally reflected in sectors such as tourism, which is going from strength to strength, and in construction which just keeps trucking on. The construction sector appears destined to have a reasonably long period of sustained growth given the long tail of residential, commercial and infrastructure (notably roading) currently being or about to be addressed.

The agricultural sector, after taking a big hit over the last couple of years with dairy bearing the brunt, has weathered the storm of low dairy payouts and now has a relatively positive outlook. This is evidenced by a recent Rabobank survey showing farmers' confidence in NZ's agricultural sector at its highest level since 2013, led by a much more optimistic outlook for dairy.

Almost half of all farmers surveyed expect the rural economy to improve in the coming 12 months. This has led to overall net confidence shooting up to 35 percent, significantly up on the net 3 percent in the last survey.

Of late the Global Dairy Trade auctions have continued to climb while Fonterra, perhaps slightly surprisingly, has upped its forecast Farmgate Milk Price by 50 cents to $5.25 per kgMS.

When combined with the 50 to 60 cents forecast earnings per share for the 2017 financial year, the total payout available to farmers in the current season is likely to be $5.75 to $5.85 before retentions. While not spectacular by any means, this does provide a degree of comfort that farmers might at least be able to break even for the current season - a lot better than predicted even 6 months ago.

Why the improved payout?

There are several possible reasons: key global suppliers' milk production is reducing in response to lower milk prices internationally, international stockpiles are being depleted and NZ's milk collection is down around 3 percent compared with last season.

The relatively bright outlook across all major sectors is reflected in increasing consumer confidence, driven by a number of factors, including better employment prospects, relatively low unemployment, low inflation, lower interest rates and consequently lower debt servicing costs. These developments support increased expenditure by increasing households' confidence to spend, while relatively strong housing price growth also provides (some) consumers with something of a feel good factor.

But despite a reasonably positive picture, issues remain, both domestically and internationally, that could deliver a fly in the ointment.

*Domestic issues, in no particular order of importance.*

First, feedback from BusinessNZ's Affiliated Industries Group (AIG) indicates optimism shared reasonably widely across most sectors, although regulatory issues and uncertainty are still holding some industries back from achieving their full potential.

Failure to grasp the nettle of regulatory reform will continue to hinder NZ's efforts to achieve its full potential. Improving the regulatory framework governing freshwater use (particularly tradability in water rights) and reviewing NZ's Foreign Direct Investment regime to allow for a freer flow of investment, particularly in so-called sensitive land, are both actions that need to be fast-tracked. Tinkering is unlikely to move the needle.

Uncertainty, particularly in the agricultural community, over land use regulation and the associated risk facing both farmers and banks is another concern. A proposed draft plan to improve water quality on the Waikato and Waipa rivers is likely to have unintended consequences, with the BNZ warning that the plan could destabilise farm values by making it difficult for land use to be changed.

While very few, if any, would object to the laudable goal of improving waterways, the potential impact on individuals and on property rights needs to be assessed before significant changes are made. And there might be some cases, if the economics of a business become unprofitable, where compensation should be offered – or paid.

If property rights are uncertain and can be changed at the drop of a hat, the incentive for companies to invest in productive assets will likely be weakened. This is quite apart from the risk to investors' equity as the uncertainty and risk involved in lending to such ventures have a flow-on effect on the price of capital as lending institutions seek a higher return on investment. Determining property rights to NZ's key natural resources needs to be put firmly on the Government's priority list.

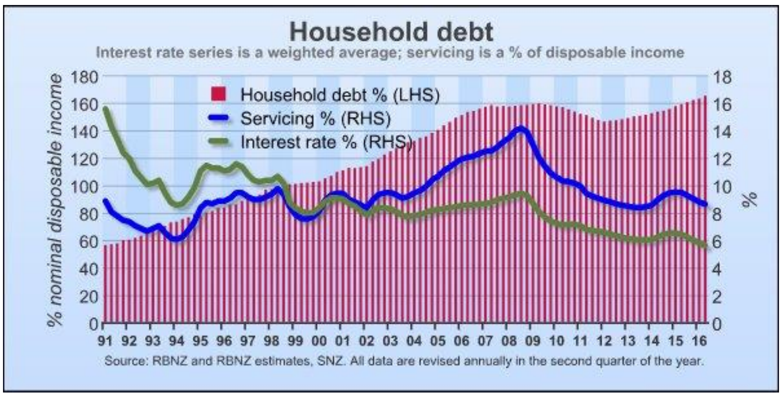
Second, household and agricultural debt continues to grow at an inflated pace, leaving households and farmers vulnerable when the interest rate worm finally turns upwards.

It is important to accept that there is good debt and bad debt, depending on its purpose and use, but the precipitous increase in household and agricultural (largely dairy) debt leaves NZers significantly exposed should asset prices burst and/or interest rates rise.

Bank lending to the dairy sector has now topped $40 billion, accounting for around two-thirds of the $60 billion banks have lent to the agricultural sector.

Banks have also loaned around $90 billion to businesses and nearly $240 billion has been advanced to households, mainly as mortgages.

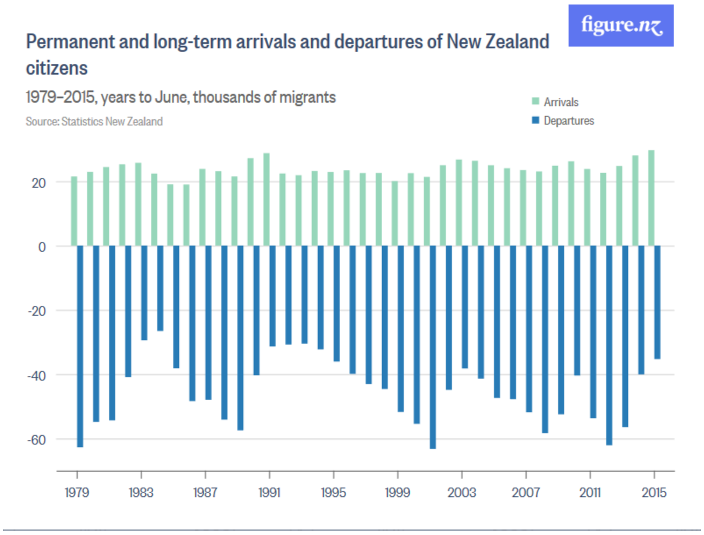
The real concern is that household debt is increasing at a time when servicing costs are relatively low, with historically low interest rates (see graph below). There is a danger that when interest rates rise, as they inevitably will (although the exact timing of the rise can always be debated), households will get into strife. Although significant household debt reduction was achieved post-2009, households appear to have partially forgotten the lessons of the past. Rising house prices might provide a feel-good factor but it is dangerous to take the price rise as representing a real increase in wealth. At the end of the day people have to live somewhere and the cost of housing will ultimately be passed on to households through higher rental costs.




Third, while continuing high levels of inward migration (mainly more NZ citizens returning and fewer leaving) is boosting domestic demand, it nevertheless puts an added strain on infrastructure and particularly housing.

Notwithstanding the above, the impact of immigration on housing must be seen in the context of the often ill-founded assumption that of the 69,000 inflow in the year to August 2016 most are foreigners coming here for a free lunch! This could not be further from the truth. Much of the net inflow is the result of Kiwis either coming home or is a reflection of those not leaving in the first place.

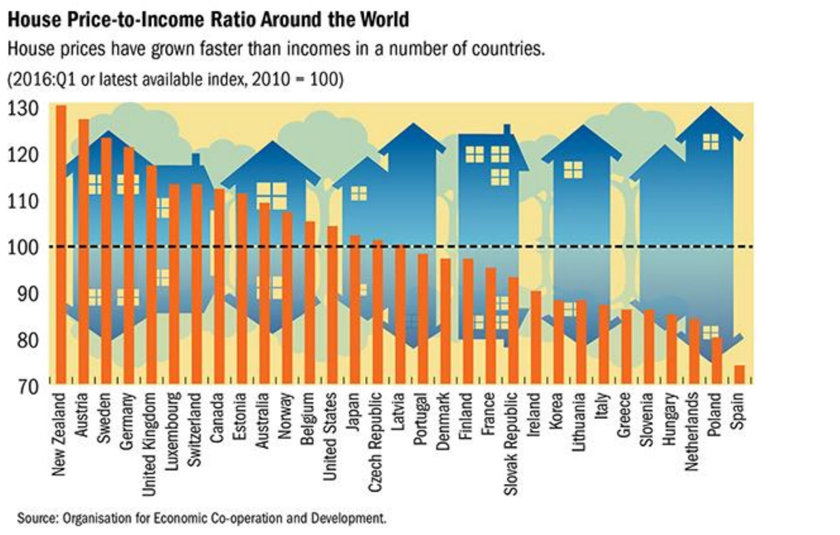
The graph below (source: figure.nz) shows that, on average since 1979, there has generally been a net outflow of around 20,000 Kiwis (i.e. 20,000 more leave than return to NZ). Over the past 2-3 years this has changed with Kiwis staying put in NZ or returning home. Around 50 percent of net migration numbers over the past few years is a direct result of Kiwi activity rather than a tsunami of foreigners seeking to take the country over!




However, it is important to appreciate that migration issues raise legitimate questions as to what long-term migration policies should be developed, what rules should attach to important property rights and what obligations should attach to living in NZ. The result could be an argument about whether or not the country should have a population policy goal, but that is another story.

Fourth, relative to income growth, housing costs in NZ have ballooned compared with those in many other countries so that housing affordability is now an ongoing issue.

It is accepted that while housing costs reflect a whole host of factors, from land supply through to infrastructure costs, building regulations, and location, compared with income levels, the cost of housing relative to incomes has stretched ahead of many OCED countries, as evidenced by the graph below. It is important to recognise that the graph is not comparing relative costs of housing across countries but does show that compared with a key source of sustainability i.e. housing to income ratios, NZ does not fare well.




The contribution of the NZ Productivity Commission's latest draft report, *Better Urban Planning,* to improving urban planning is significant. The report provides a thorough and reasoned explanation of what is wrong with urban planning currently and includes a number of considered findings and recommendations. In particular, BusinessNZ readily endorses a key finding, that: *"The [current] planning system shows considerable evidence of unnecessary, excessive and poorly-targeted land use regulations".*

BusinessNZ's position (set out in a number of our recent submissions) is that business and individuals should generally be able to develop land as they see fit provided they bear the associated economic and environmental costs (i.e. costs should be internalised to a reasonable degree).

Only minimal regulation is required and when it is imposed, this should be only when regulation is specifically in the public interest.

The real problem is that as long as planners constrain land supply - as they will continue to do under the Government's proposed National Policy Statement on Urban Development Capacity - the price of land zoned urban will remain well above that of the same or equivalent rural-zoned land. Consequently, the many planning dislocations and unintended absurdities will continue.

Tying the release of land and/or changes to land use to political trigger points (e.g. land values) will see private property provided in locations and under conditions both of the planners' choosing and political necessity.

The consequence, as some commentators have pointed out, will likely be "upzoning", not necessarily where there are better amenities and infrastructure, nor the highest demand, but rather fewer people opposing development.

Potential benefits from an NPS are likely to be outweighed by the risks associated with:

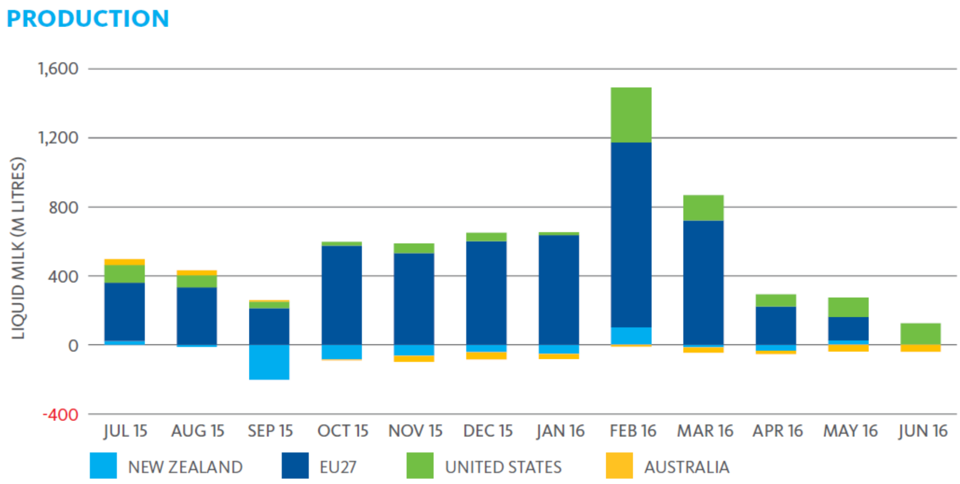
- Unintended consequences (i.e. uncertainty as to the effects the policy could have, including an effect neither anticipated nor desired);
- The potential for regulatory creep (i.e. the process of developing an NPS could result in moves from high level principles to detailed prescription on resource use, reducing the potential for economic growth). In short, replacing the current failed planning system with an even more prescriptive planning system; and
- Councils having to second guess how much land to make available and burdened with unnecessary and bureaucratic reporting requirements they cannot realistically be expected to fulfil.

Fifth, NZ's share market has gone from strength to strength but current levels suggest share prices are overinflated compared with earnings. This could result in a significant correction at some stage (perhaps if the US central bank raises its key lending rate) although given NZ's financial stability, it is not likely to be a significant concern. Unlike housing, where substantial debt is involved, banks or other lending institutions are not likely to be exposed in any material way should the share market take a dive.

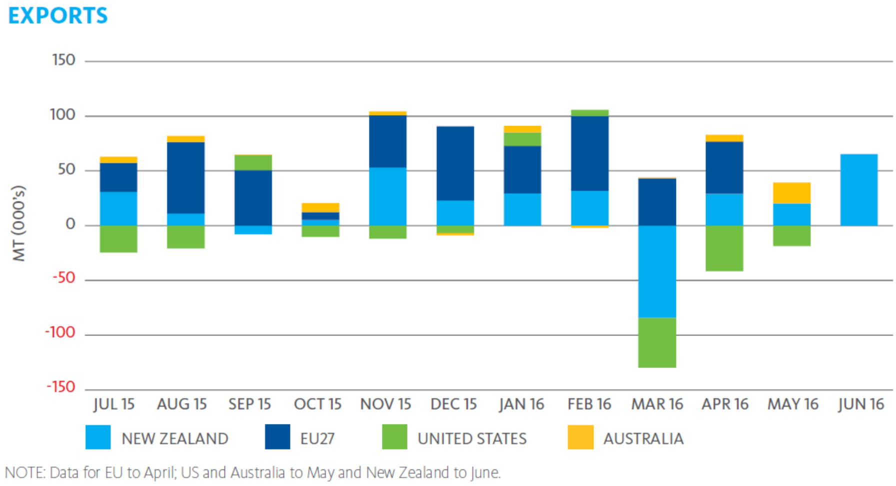
Sixth, NZ is exposed to significant shifts in international commodity prices, in the dairy sector at least.

The NZ situation is perhaps not widely understood. NZ is a very small player when it comes to total world milk production but a key player in terms of the international trade in milk products. Consequently the country is particularly susceptible to relatively small changes in world production with milk producers here affected by any significant price movements - the case over the last few years. The two key graphs below illustrate this point.

The first graph shows the year-on-year changes in production for a range of countries that are also key players in the global dairy trade. The second graph (over page) shows exports by country over the same period, reinforcing the point that NZ is a small player in world production terms but a major exporter of dairy products.




NOTE: Data for EU to May; New Zealand, US and Australia to June.




*International issues, again in no particular order of importance.*

First, the slow-down in China which, along with Australia, is NZ's biggest and fastest growing market, particularly in respect to dairy.

China and Australia account for around a third of NZ exports, and while since the 2008 NZ-China free trade agreement growth in China has been phenomenal, NZ is exposed to any potential slowdown there and/or in Australia.

Second, the ongoing threat of terrorism, something world powers are finding difficult to address. However, this international concern could have a positive impact on NZ if international tourists make their way here, seeing the country as a relatively safe destination.

Third, Brexit has the potential to encourage some parts of the world to revert to protectionism and reduced trade, even though predictions of economic collapse have been exaggerated. NZ exporters have had assurances from Britain and the European Union that there will be no change in access for NZ's goods or people until new conditions are negotiated. A time frame likely to extend over 2-4 years will allow for the orderly and seamless exit of Britain from the EU.

Fourth, the outcome of the Trans-Pacific Partnership (TTP) is still in the balance with concern about President Obama's ability to get the agreement through Congress before the US elections. Some fear there might not be another opportunity to achieve such an agreement if the current deal fails to get through. Anti-free trade rhetoric has become much louder in the US of late with presidential candidates Donald Trump and Hillary Clinton leading the charge.

Fifth, international monetary policy settings continue to be way out of whack in a number of countries, with negative interest rates now the norm in a number of developed countries. Some years ago this would have been seen as laughable. The threat of deflation should not be totally discounted and deflation would significantly harm investment.

### *1.2 Monetary conditions – way on down*

#### *Interest rates – low and lower still*

The 90-day bill rate is forecast to decline slightly for the year to September 2017 and lift marginally out to September 2018 (see forecasts below).

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

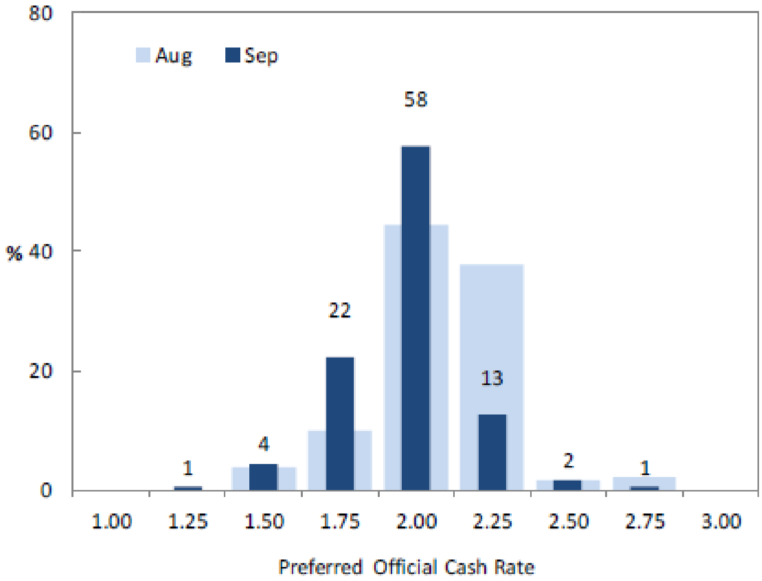
| | Years ending | | |
|---|---|---|---|
| | Sep 16 | Sep 17 | Sep 18 |
| Highest | 2.3 | 1.9 | 2.6 |
| Average | 2.2 | 1.8 | 2.0 |
| Lowest | 2.2 | 1.7 | 1.8 |

*Source: ANZ, ASB, BNZ and Westpac*

As most expected, the Reserve Bank kept the Official Cash Rate at an historic low of 2.0 percent in its most recent review but implicitly signalled that a further cut is likely later this year.

The NZ Institute of Economic Research's (NZIER's) Shadow Board recommended the Bank continue to hold the OCR at 2.0 percent. The Board expressed a wide range of views but on balance there was an underlying preference for a cut in the rate. The Shadow Board's average recommended interest rate fell from 2.08 percent in August to 1.95 percent in September.

**Figure 1 NZIER's Shadow Board recommends the Reserve Bank remains on hold but with an easing bias**




Source: NZIER *Monetary Policy Shadow Board*

In releasing the results of the Shadow Board's decision, Christina Leung, NZIER Senior Economist said:

*"The Shadow Board recommends the Reserve Bank keeps the OCR on hold at 2 percent….but suggests there is also scope for further easing. The tension between weak inflation and rapid house price acceleration remains very taut, with the higher NZ dollar also adding to the Reserve Bank's dilemma. Nonetheless, the Reserve Bank's primary focus on inflation means further easing is likely."*

The tension referred to above between rising house prices and a continuing subdued inflation outlook is difficult for the Reserve Bank to navigate but there are reasons why the Bank should think very carefully before making any further cuts to the OCR. This is despite several respected economists considering the Bank will lower the OCR later this year (before possibly raising rates to more neutral levels further down the track).

First, while headline inflation (which measures consumer prices) is still outside the Reserve Bank's target band of 1-3 percent, core inflation, discounting one-offs, is much more in the line of 1.5 percent. There is an argument that the public is more in tune with headline inflation but the Bank's role is to look broadly through one-off results and focus on the longer term. Therefore it can be argued that core inflation is a more credible number for the Reserve Bank to target over the medium term.

Second, the broad NZ economy is now performing relatively strongly (after an earlier dip in 2015). With strong and prolonged high net inward migration levels and continued housing price pressures, lowering the rate might fuel even greater domestic demand putting the economy at risk. Commodity prices, including dairy, have now started to rebound after being in the doldrums for the past couple of years.

Third, with interest rates at historically low levels, it is debatable whether lowering them even further would have much impact on investment activity. Investment opportunities and risk might be more dependent on the regulatory framework than on interest rates per se.

On the other hand, the continued appreciation in the value of the NZ dollar is taking the heat out of any potential tradables inflation, leaving the Reserve Bank between a rock and a hard place - not an easy time to be Governor of the Reserve Bank.

***The NZ dollar – difficult to pick***

The differences in the forecasts below of potential exchange rate outcomes yet again reinforce the extreme difficulty in clearly predicting what will happen in the future.

Inflaming the uncertainty is that moves towards more normalised international monetary policy regimes are still looking a long way off even though the United States is likely to raise interest rates before the end of this year. There are countries with negative interest rates clearly struggling for solutions and a handful of developed countries with rates close to zero. NZ's OCR of 2.0 percent looks positively high by international standards.

Also noteworthy is the International Monetary Fund warning that the global economy is vulnerable to shocks such as sharp currency devaluations and worsening geopolitical conflict. The IMF also cites the risk of political isolationism.

***Forecasts: Exchange Rates***

| AUD (cents) | | | |
|---|---|---|---|
| | Sep 16 | Sep 17 | Sep 18 |
| Highest | 0.97 | 0.96 | 1.01 |
| Average | 0.97 | 0.95 | 0.92 |
| Lowest | 0.95 | 0.93 | 0.87 |

| USD (cents) | | | |
|---|---|---|---|
| | Sep 16 | Sep 17 | Sep 18 |
| Highest | 0.74 | 0.72 | 0.75 |
| Average | 0.73 | 0.67 | 0.68 |
| Lowest | 0.73 | 0.65 | 0.60 |

| TWI | | | |
|---|---|---|---|
| | Sep 16 | Sep 17 | Sep 18 |
| Highest | 78.3 | 75.0 | 75.2 |
| Average | 77.4 | 72.5 | 71.4 |
| Lowest | 76.5 | 69.0 | 67.3 |

*Source: ANZ, ASB, BNZ and Westpac*

***Inflation – down and out***

Forecasts below show inflation firmly under control over the period to June 2018, remaining well within the Reserve Bank's target range of 1-3 percent and only reaching 2.0 percent by September 2018.

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

| | Years Ending | | |
|---|---|---|---|
| | Sep 16 | Sep 17 | Sep 18 |
| Highest | 0.3 | 1.9 | 2.1 |
| Average | 0.1 | 1.5 | 2.0 |
| Lowest | -0.1 | 1.1 | 1.7 |

*Source: ANZ, ASB, BNZ and Westpac*

Tradables inflation has not been an issue to date with increases in commodity prices being largely offset by an appreciating NZ dollar. On the other hand, non-tradables inflation - particularly housing - is a problem, with significant and ongoing pressures now spreading well beyond Auckland. For reasons of financial stability, this is likely to concern the Reserve Bank much more than other inflationary pressures, hence greater recent intervention such as loan to value ratios, a mechanism intended to curb demand and thereby help to stabilise house prices.

Notwithstanding current headline inflation, it is important when setting monetary policy, to take the horizon as the next 2-3 years and not respond with a kneejerk reaction to current headline rates.

Oil prices have bottomed out and global commodity prices, in general, are starting to recover, so NZ should not be too smug about assuming low inflation is here to stay.

An interesting fact about inflation is that of recent years both global competition and innovation have cranked up 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 now as it did in the past. Prices over a wide range of products and services are in real terms, and indeed even in nominal terms, dropping. This is a significant shift away from the traditional (past) assumption that generalised inflation is here to stay.

## 1.3 Business activity and consumer confidence firming

***Business activity cranking up***

Business activity and consumer confidence are generally improving as evidenced by a number of qualitative and quantitative surveys.

The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the BNZ-BusinessNZ Performance of Services Index (PSI) both show continued solid growth.

The seasonally adjusted PMI for August 2016 was 55.1, that is, 0.4 point lower than in July, but still representing healthy growth for manufacturing in NZ. (A PMI reading above 50.0 indicates that the service sector is generally expanding; below 50.0 that it is declining).

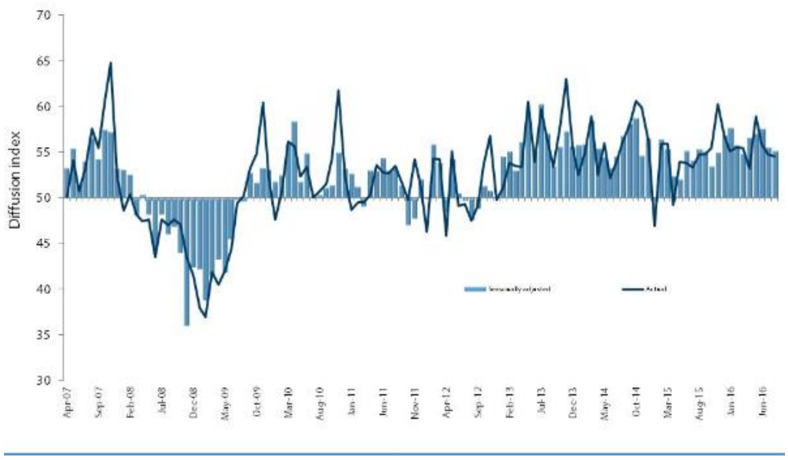
The sector remains solidly in expansion in almost all months since October 2012.

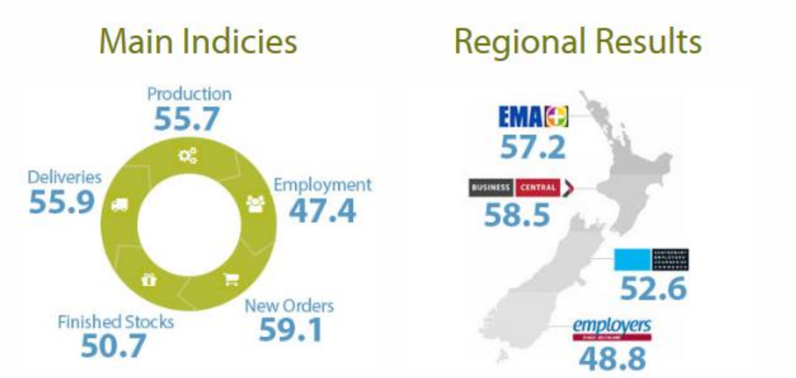
The five sub-indexes showed varied movements in activity since June. Production (55.7) slipped slightly although new orders (59.1) remained strong.

The slight dip in overall expansion was mirrored by the proportion of positive comments decreasing to 58.4 percent for August, compared with 62.8 percent in June and 63.8 percent in July. A number of negative comments were centred on this time of year being typically quiet, while positive comments tended to focus on ongoing orders, as well as preparations for the summer season.

***NZ-BusinessNZ Performance of Manufacturing Index (PMI)***

***(2007 onwards)***

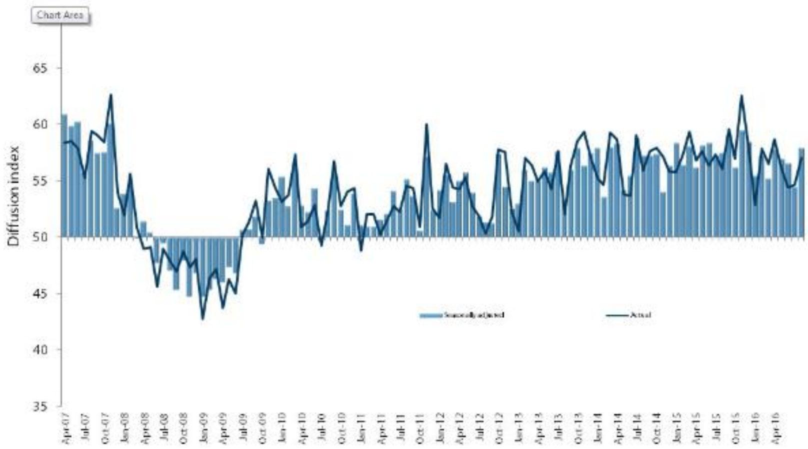





The BNZ–BusinessNZ Performance of Services Index (PSI), continued strongly, with expansion continuing in August 2016. The PSI for August was 57.9.  This was 3.4 points up from July, and the highest value since December 2015 (A PSI reading above 50.0 indicates that the service sector is generally expanding; below 50.0 that it is declining).

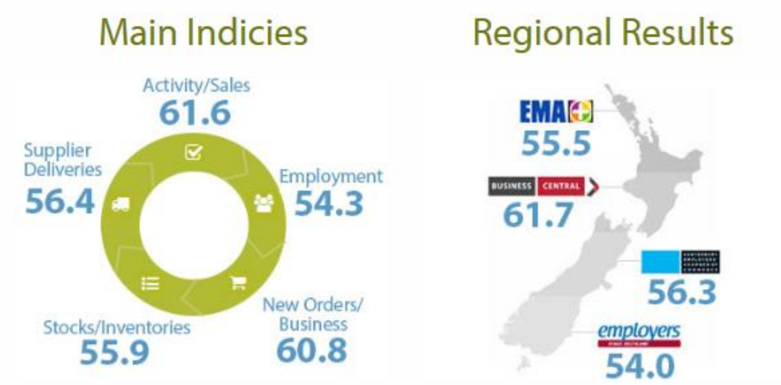
***BNZ-BusinessNZ Performance of Services Index (PSI)***

***(2007 onwards)***




It is pleasing to see all sub-indexes improve from July, with activity/sales (61.6) and new orders/business (60.8) both rising back above the 60 point range.

Looking at the comments, the proportion of positive comments for August (65.2 percent) was largely unchanged from July (65.6 percent), with a number mentioning new customers and markets creating enhanced opportunities for growth.



Other sectors are also showing continued or renewed levels of confidence.

The agricultural sector, after taking a big hit over the last couple of years with dairy bearing the brunt, has since weathered the storm of low dairy payouts. The agricultural sector now has a positive outlook and a recent

Rabobank survey shows farmers' confidence at its highest level since 2013, led by a much more optimistic outlook for dairy.

The outlook for construction is very positive with a number of major infrastructure projects, along with residential housing and commercial buildings (including earthquake strengthening) ensuring the sector maintains significant activity levels for the foreseeable future.

Tourism numbers continue to grow despite a relatively high NZ dollar with increased numbers reflected in accommodation and hospitality statistics.

The ANZ Business Outlook for August 2016 reinforces the perception that business confidence remains robust.

After adjusting for seasonality, business confidence hit a 20-month high in August. Perhaps more importantly, the net number of firms optimistic about their own businesses increased marginally to a net 34 percent.

Underlying the drive towards improved confidence is the rise in investment intentions to a net positive 22 percent, the highest since March 2015, while employment intentions lifted 2 points to a net positive 19 percent.

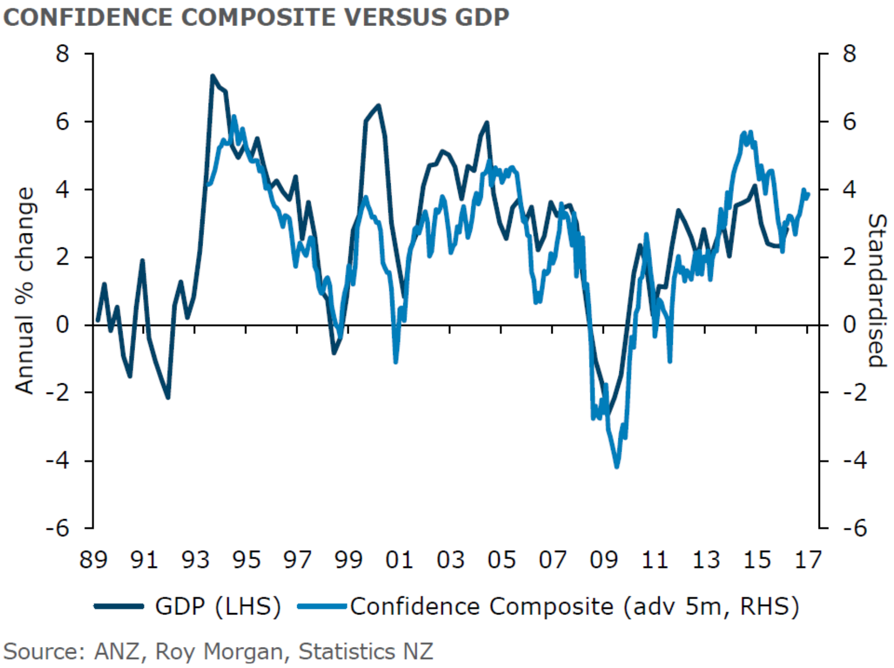
Consumer confidence is also strengthening.

Given a relatively bright outlook across all major sectors, this is now reflected in increasing consumer confidence driven by a number of factors, including better employment prospects and relatively low unemployment, both making households more confident to spend.

While an appreciating NZ dollar is not generally positive for most exporters, it does result in lower prices to consumers, providing a spark to fuel expenditure.

Low inflation and consequently lower interest rates and debt servicing costs are supporting increased expenditure. Relatively strong housing price growth is also providing consumers with something of a feel good factor, encouraging them to open their wallets.

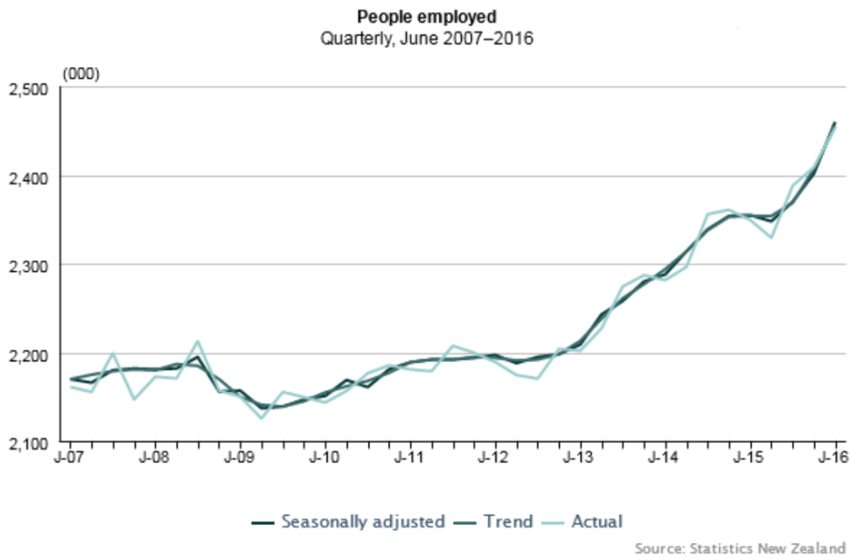
The ANZ confidence composite indicator – which combines both business and consumer sentiment - is pointing to GDP growth lifting towards 3.5-4 percent over the year ahead (see graph below).



### 1.4 Labour market – positive outcomes

***Employment – growth continues***

Employment's upward climb is evidenced in the graph below.




Unemployment has continued to drift lower to reach 5.1 percent in the June quarter 2016.

The mix of factors impacting on labour market outcomes includes continued strong population growth, reflecting in part strong net migration inflows, although as stated earlier, much of the increased in net migration is driven by fewer NZers leaving NZ and more NZ citizens returning as the economy has continued to improve. This level of migration might now have peaked but there is unlikely to be any substantial tightening of labour market conditions this year.

Despite relatively strong employment growth, forecasts below show the unemployment rate projected to drift only slightly lower to reach 4.8 percent in the year to June 2018.

***Forecasts: Unemployment percentage (HLFS)***

| | Quarter | | |
|---|---|---|---|
| | Sep 16 | Sep 17 | Sep 18 |
| Highest | 5.1 | 5.0 | 5.2 |
| Average | 5.0 | 4.9 | 4.8 |
| Lowest | 4.9 | 4.7 | 4.5 |

*Source: ANZ, ASB, BNZ and Westpac*

A number of surveys show employment confidence continuing to rise with perceptions about the availability of job growth continuing to strengthen.

The ANZ Jobs Ads series for August 2016 shows job ads rising 3.1 percent in August on a seasonally-adjusted basis – the seventh consecutive monthly lift. Job ads are now over 12 percent higher than a year ago.

Auckland continues to lead the charge with job ads 14.1 percent higher than a year ago, Wellington job ads were up 11.5 percent on a year ago while Canterbury job ads were 8.8 percent lower than a year ago (3-month average). The Canterbury results need to be put in context given the huge growth in employment there over the last few years as a result of the ongoing rebuild and redevelopment post the 2011 earthquake and the fact that Canterbury continues to experience record low unemployment.

A number of the regions are showing relatively strong growth, despite the dairy sector's difficulties and contraction over recent quarters. This suggests that the construction and tourism sectors are booming and compensating for the weaker labour market conditions currently experienced by the dairy sector. Overall, this indicates a much more rounded economy where regions are not totally dependent on the vagaries of one sector to produce their wealth.

***Labour costs – generally subdued***

Forecasts below indicate labour costs are expected to increase only slowly to 2.0 percent for the year ending September 2018.

Reasonably solid employment growth notwithstanding, the high numbers of people entering the labour market, including the ongoing impact of strong net inward migration, will likely see wage pressures generally contained. However, on balance, wage pressures are likely to start building not only due to normal supply and demand conditions but also to other factors impacting on individuals' disposable income after the basics, such as taxes and housing costs, have been taken out.

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

| | Years ending | | |
|---|---|---|---|
| | Sep 16 | Sep 17 | Sep 18 |
| Highest | 1.7 | 2.1 | 2.1 |
| Average | 1.6 | 1.9 | 2.0 |
| Lowest | 1.6 | 1.7 | 1.9 |

*Source: ANZ, ASB, BNZ and Westpac*