BUSINESS NZ

PLANNING FORECAST

Business NZ

DECEMBER 2008

We live in interesting…..and uncertain times

Executive summary

Economy

In Ancient China there was a saying: "May you live in interesting times." While some view it as a polite way of making a derogatory comment, sometimes the most difficult times are the most interesting and for some can end up even providing positive opportunities. They challenge us, they test us, and occasionally they can even bring out the best in us. The economic times we are living in are nothing if not interesting, but also very uncertain. In a relatively short space of time the game has changed from what New Zealand has been used to over recent years, and uncertainty about how both New Zealand's and the world's economy will perform leaves more questions than answers.

Since the last business planning forecast the full weight of the credit crunch has come hurtling down. Stockmarkets are batted, economies are shaken and people are fearful of what the future holds. Therefore, it is more important now than ever to look past the often sensational headlines and get a more accurate picture of what is really going on, and where things may head over the coming 1-2 years. Getting an accurate picture of what lies ahead by looking at what has happened before is fraught with problems, as there has been what could be described as a trend change over the last few months.

If we are to look strictly at the New Zealand economy, there are positives and negatives on both sides, although the negatives are currently winning. On the positive side, the high New Zealand dollar has dropped considerably against most major countries, making our exports more competitive. The cost of borrowing is becoming cheaper with interest rates currently dropping at a fast clip. The inflation hump seems to be past with petrol prices falling and a probable easing of wage expectations as job security becomes more of a pressing issue. However, the full effects of the large credit crunch tsunami have yet to hit New Zealand, and will bring things such as lower offshore orders, falling confidence, consumers closing their wallets, ongoing house price falls, cuts in employment and decreased commodity prices.

From a business perspective, many businesses will have to make some tough decisions such as they have not been used to making over recent years. Whether these decisions will be generally negative (cut staff, decrease capital expenditure, hold back on new products/services) or positive (look at new markets, add/diversify products/services, acquire other businesses) will provide a steer towards how fast New Zealand bounces back out of any recession. It will be the private sector that ultimately gets New Zealand back on the growth path.

HIGHLIGHTS

Growth is expected to remain negative for the remainder of this year, and still remain well below the norm for 2009. A slow pickup is likely in 2010.

World commodity prices have come off their historically high levels and continue to drop. Taking into account the NZ dollar depreciating, any improved returns for New Zealand exporters will also depend on the drop off in global demand.

Further falls in both the NZ dollar and interest rates are expected over the next year, with further OCR movements expected in the coming months.

Inflationary pressures look to have reached their peak, while a significant easing in oil prices will help bring quarterly movements downwards.

Numbers unemployed are expected to move upwards, with the unemployment rate expected to reach 5.5% by the end of 2009. However, if the global financial crisis deepens, this could well be revised upwards.

Part 1: The New Zealand Economy

1.1. Economic growth (GDP) – continuation of a negative run likely

Most recent outcome: +2.6 per cent for the year to June 2008

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

Officially NZ was technically in recession (defined as two consecutive quarters of negative GDP growth) for the first half of 2008 as confirmed with the recent release of GDP figures for the June quarter 2008 which showed the economy slipping backwards by 0.2 percent for the quarter. GDP was down 0.3 percent for the previous quarter. Annual growth was still a relatively healthy 2.6 percent for the June 2008 year, although it is likely that growth for the September quarter will also be negative.

The flow-on effects of the drought early this year are continuing to impact on agricultural production with activity in primary industries down 0.6 percent in the June 2008 quarter.

Total export volumes decreased 0.2 percent for the June quarter, mainly due to a 17.7 percent decrease in exports of dairy products. On the other hand, total import volumes were up 3.3 percent, but some of this increase was due to the import of "one-off" items relating to the oil industry, reflecting a strong investment in plant machinery and equipment (up 15.6 percent) for the quarter.

Service industries recorded their first quarter of negative growth since 2002, down 0.4 percent for the June 2008 quarter. The largest contributors to this decline were finance, insurance and business services (down 0.7 percent), retail, accommodation and restaurants (down 1.9 percent) and wholesale trade (down 1.2 percent).

Activity in goods-producing industries was down 0.2 percent in the June 2008 quarter, with construction activity (down 3.8 percent) the main contributor to the decline. Perhaps surprisingly, offsetting this negative outcome was an improvement in manufacturing activity (up 1.4 percent in the June 2008 quarter). However, the increase in manufacturing activity was largely due to a 2.6 percent increase in food, beverage and tobacco manufacturing.

Looking at the average predictions below, annual growth is expected to still remain in positive territory at the end of 2008, with some upwards movements by the end of 2009. Only by 2010 do we see growth at a level that would provide anywhere near the levels seen over the last 8 years. The potential 'spanner in the works' is the extent to which the global financial crisis will filter through to global growth, with every chance that recovery will take longer than some have originally thought.

Forecasts: Real GDP % Growth

	Years Ending		
	Dec 08	Dec 09	Dec 10
Highest	0.8	1.5	3.6
Average	0.7	1.0	2.9
Lowest	0.5	0.5	2.5

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

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

Interest rates – some deep diving taking place at present

Overall, there was a radical shift in thinking regarding the OCR due to events in September. At the time of writing our previous economic forecast, any significant cut in the OCR was deemed to be reckless by many, given the inflation headache in existence. However, the events in September suddenly turned heads towards core growth as the key issue to contend with after adverse events offshore.

The Reserve Bank created history recently by lowering the OCR by its biggest level since it began in 1999, from 7.5 per cent to 6.0 per cent at the last review. Further cuts are almost guaranteed over the coming months, with their level based on evidence of actual reductions in domestic cost pressures and reflecting global financial developments.

Certainly, some of the key pump primers for inflation have softened recently. The most notable has been oil prices, dropping from record highs of around $US147 per barrel mid year to now around US$65, more than a 50% fall. Falling growth will also curtail other inflation contributors, although the Reserve Bank still has concerns that domestically generated inflation (particularly in labour costs, local body rates, electricity prices and construction costs) is remaining stubbornly high.

Economists are somewhat divided about how low and how quickly the OCR will fall. Obviously, the Reserve Bank is keen to see other inflationary elements subside, but predictions range from around 4.75% to 5.5% come the end of the first quarter in 2009. Whatever the otucome, one would expect the OCR to drop by some level for at least the next two rounds.

Official Interest rates

Central Bank	Current rate (%)	Previous rate (%)
Reserve Bank of Australia	6.00%	7.00%
US Federal Reserve	1.00%	1.50%
Bank of England	4.50%	5.00%
European Central Bank	3.75%	4.25%
Reserve Bank of NZ	6.50%	7.50%

The New Zealand Dollar – tale of the two As

After a number of promising but ultimately false starts, it is almost universally accepted that a continued easing of the New Zealand dollar against most major currencies has now taken place. However, it has thrown up a few curve balls when comparisons are made on a country by country basis.

After a steady fall against the Australian dollar down to Aus 77 cents, the NZ$ recovered somewhat after August, but then experienced a significant boost due to the 100 base cut in the Australian cash rate, causing the NZ$ to increase rapidly from Aus 81.5c to 92c. Since then it has dropped to Aus 87c, so a volatile time for exporters. In contrast, against the US there has been a consistent fall, from a relative high of US 81.5c in March to around 60c by October. With Australia a first port of call for exporting, the rapid lift against the Australian dollar would not have provided a good outcome for export receipts. On the flip side, those primarily exporting to the US would have welcomed the currency relief, with probably little prospect of getting anywhere near US0.70-80c in the short-medium term.

On a trade-weighted index (TWI) basis, the TWI has dropped from a high of around 74 cents to sit around 59 cents currently (a 20 per cent reduction over the past seven months).

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

Net migration flows – bottoming out?

Over 2004-06, relatively large migration inflows, on average, boosted domestic consumer spending, car sales and house building. Migration has helped mitigate some of the pressures building up in the labour market. However, over the last year or so, net migration flows have continued to slow, and appear to have reached somewhat of a plateau over recent times when looking at the results on an annual net migration level.

A net inflow of 40,800 non-New Zealand citizens and a net outflow of 36,400 New Zealand citizens were recorded in the year ended September 2008. The majority of the net outflow of New Zealand citizens was to Australia (34,000) followed by the United Arab Emirates (500) and Canada (400).

Overall, there was a net gain to New Zealand's population in September of 1,706 people, 535 fewer than a year earlier, and the annual migration gain has declined to 4,403 from 4,938 in August. In comparison, this figure was at 8,319 a year ago. However, given the current economic climate, there is the possibility that many New Zealanders will look to be heading home as job prospects wither offshore, possibly boosting net migration figures in the months ahead.

Commodity prices – slipping down

It appears the peak may have been reached for commodity prices, as official numbers show some downward movement starting to appear, albeit off a very high base.

The ANZ Commodity World Price Index stood at 295.5 for September 2008. This was 4.9% below the result for August, and followed a 3.3% drop in August. The Index was also 1.9% down on the same time the previous year. When converted into NZ dollars, the ANZ NZ Dollar Commodity Price Index stood at 165.1, down 0.9% from the previous month, but up 3.6% from the previous year.

The drop in the World Price Index was largely due to continued sharp falls in dairy prices, recording a 7.9% drop during the month of September. In fact, the September fall was the sharpest monthly fall in 21 years (albeit coming off very strong highs). For other commodities, six recorded lower prices, while four recorded uplifts. Of the former, aluminium and beef were most affected, while apples and seafood were the main drivers in the latter category.

Although the dollar slide occurred while the latest commodity price index was in train, the fall was not substantial enough to offset the falling export prices, hence the NZD commodity price index also dropped. The New Zealand dollar has continued to fall in recent weeks, particularly against the US$. Therefore, there may be some uplift in the NZD commodity index looking forward, although that will be dependant on how much demand softens as the global recession continues to bite.

	World Price Index	Monthly % Change	Annual % Change	NZ$ Index	Monthly % Change	Annual % Change
Sep 2003	123.7	2.1	9.5	111.2	2.1	-10.5
Sep 2004	151.0	0.2	22.1	122.5	-0.6	10.2
Sep 2005	152.4	-1.0	0.9	116.3	-1.4	-5.1
Sep 2006	154.3	0.8	1.2	127.3	-2.4	9.5
Sep 2007	209.4	0.4	35.7	159.3	1.5	25.1
Sep 2008	205.5	-4.9	-1.9	165.1	-0.9	3.6

Source: ANZ Commodity Price Index NZ – 2 October 2008

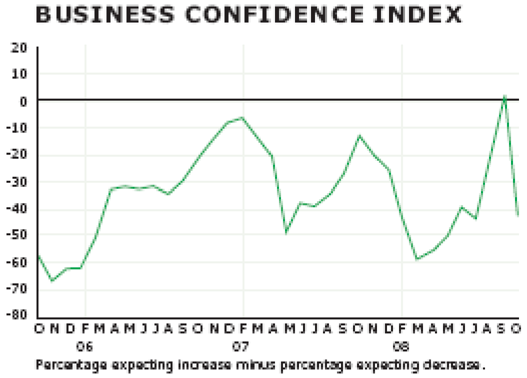
Business confidence – A sharp correction downwards

Previously reported results are one of the first casualties of any sudden impact on an economy, becoming somewhat irrelevant as an indicator of what may be to come. Confidence surveys are probably the most affected, as sentiment can often change on a dime if there is a perception that the winds of change have turned into a hurricane. This is best exemplified by the most recent data for the two major business confidence surveys.

After initially dropping by a third in the December quarter 2007 and staying at low levels throughout the first half of 2008, business confidence rebounded significantly over the September quarter when looking at the NZIER's Quarterly Survey of Business Opinion (QSBO). In it, a net 24% of firms expected the general business situation to deteriorate over the next six months, compared with 54% for the previous survey. This improvement in sentiment was shared across all the major sectors surveyed, with the depreciation of the New Zealand dollar and drops in interest rates being the primary factors for believing there was some light at the end of the tunnel.

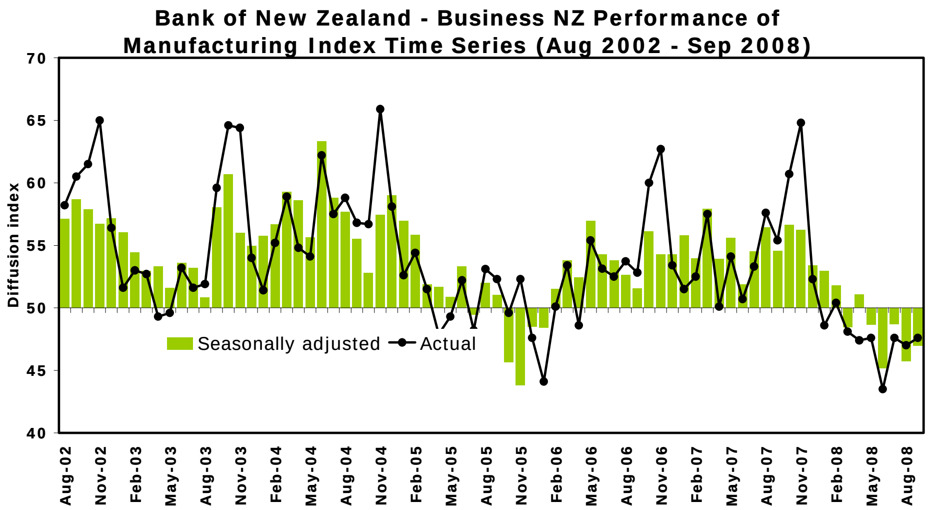
However, the latest results of the National Bank's Business Outlook for October shows a very different picture, and a reversal back to the low confidence businesses had felt during most of 2008. In fact, there was a massive 44 point turnaround from September, the largest one month fall in the history of the survey. Every sector was dismal about the future, and firms' own expectations fell from plus 17 to minus 11 (the second lowest result on record). Employment intentions also dropped to a historic low, with 21% of respondents expecting to employ fewer staff.

National Bank Business Confidence Index



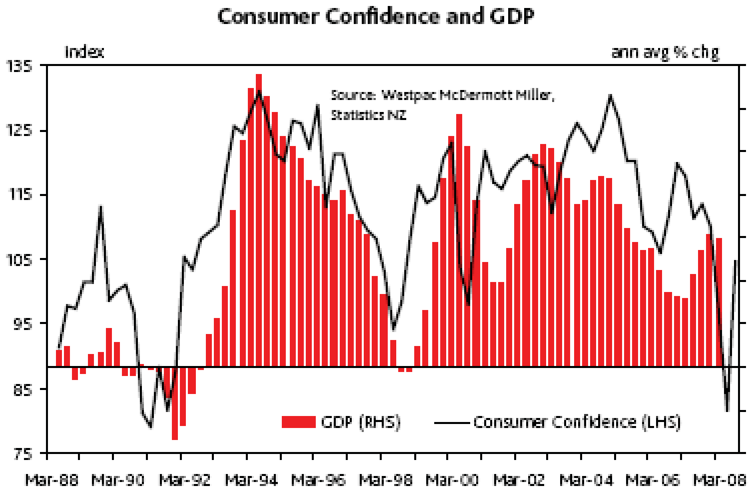
Other indicators of business confidence also show that negative sentiment abounds. The Bank of NZ – Business NZ Performance of Manufacturing Index (PMI) and Performance of Services Index (PSI) both continue to show sectors in contraction. The PSI (for the month of September 2008) shows the index at its second lowest level (46.9) since the series began in April 2007, along with six straight months of contraction. In particular, the retail trade and accommodation, cafes & restaurants sub-sectors have been worst hit, as people's wallets clamp shut on further discretionary spending.

The PMI provides much more useful data given the series has been going for more than six years. Again the results show a continued slowdown in activity levels with the series having been in negative territory for the last six months (currently 46.9 on a seasonally-adjusted basis for the month of September 2008). This is now the longest period of contraction since the survey began.



Consumer confidence – sigh of relief for consumers may be short lived

According to the headline for the latest Westpac McDermott Miller Consumer Index, consumers voiced a collective sigh of relief, as confidence staged an unprecedented recovery during the September quarter. The index lifted to 104.8 in September – a recovery of 23.1 points from June when it reached a 17-year low. A bounce back to a certain extent would be expected, especially when the time series of results are also studied, as the graph shows below.



In light of what has happened to the global economy over recent weeks, one wonders whether this may be the shortest recovery ever recorded, especially when the biggest driver of the lift in confidence was a sharp improvement in the economic outlook over the next 12 months.

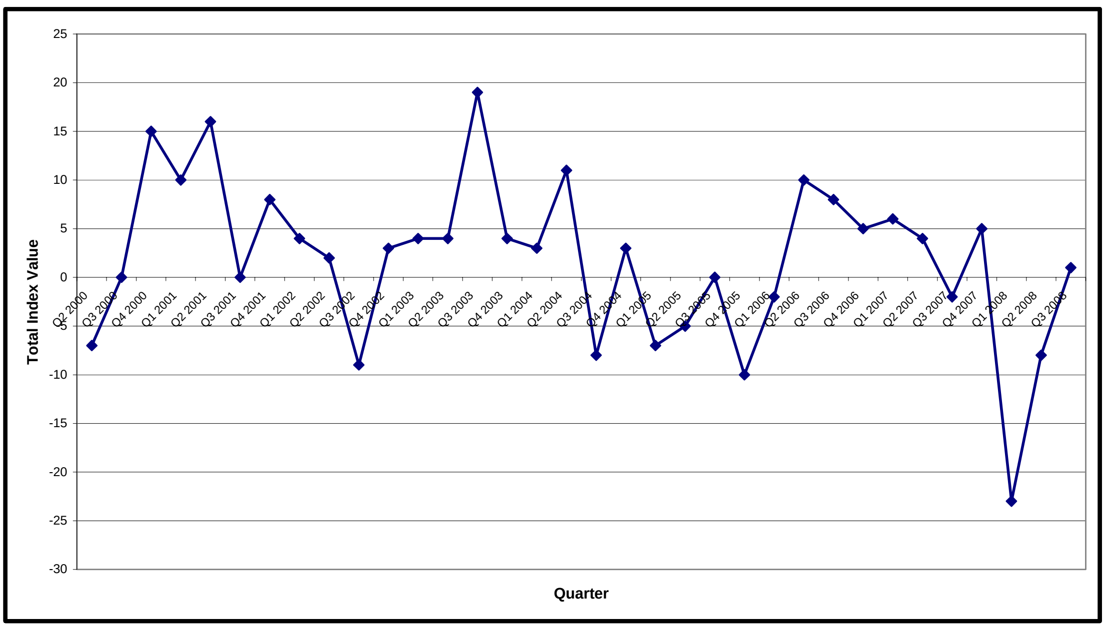
There's every possibility that consumers will batten down the hatches over the near term as the housing market takes a pounding during the next few months and expectations of further employment cuts flow through. These pressures being brought to bear on consumers have seen in cheque books put in the bottom drawer, as reflected in a number of indicators such as electronic card transactions, retail sales (with motor vehicle retailing continuing to take a hit as consumers pull back on discretionary spending) and a further trend downwards in building consents.

Putting it all together – a dead cat bouncing?

The overall Business NZ Economic Conditions Index (a measure of the major economic indicators) sat at +1 for the September 2008 quarter, up 9 on the previous quarter and a significant 24 on the March quarter.

While the overall index now sits on the positive side of the ledger (just), as discussed above the economic outlook has deteriorated rapidly with the international credit crunch resulting in a repricing of credit risk and a generally lowering world growth outlook. Despite measures by Governments and central banks around the world to shore up financial markets, markets remain extremely volatile. World commodity prices have plunged but on the positive side the heat has gone out of international inflationary pressures, with international oil prices dropping by over 50% in the last three months.

Business NZ Economic Conditions Index



Inflation – has it had its day?

Most recent outcome: +5.1 per cent, year-ended September 2008

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

The September quarter 2008 CPI rose 1.5% on the June quarter, following on from a 1.6% increase during the June quarter. This has brought headline annual inflation to 5.1% – the highest annual increase since the year to June 1990 quarter, and obviously way outside the Reserve Bank's target range of 1-3%.

The main drivers of the increase for the September quarter were in the food, housing & household utilities and transport groups.

Food prices increased 3.7%, driven by higher prices for vegetables (a reflection of the very wet growing season).

Housing and household utilities prices rose 1.4%, driven by higher prices for local authority rates and payments.

Transport prices rose 2%, with the main contribution coming from higher prices for petrol.

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

Despite inflation reaching heights not seen for almost two decades, there are indications that it has reached its peak, and any further overall movement will be downwards. International oil prices continue to be the main mover downwards. From a peak of US$147 per barrel some months ago, the price of oil currently sits at around US$67, which has meant some relief at the pump, albeit not as much as many anticipated due to the deteriorating New Zealand dollar. House prices continue to ease, while pricing intentions from business surveys show a downwards trend, and capacity pressures are also easing. Counteracting this to some extent will be the ongoing drop in the New Zealand dollar, which has shed a considerable amount of its value recently, particularly against the US dollar.

The Reserve Bank has generally taken the view that the worst of the inflation pressures are now behind us, although there are still concerns that domestically generated inflation (particularly in labour costs, local body rates, electricity prices and construction costs) is remaining stubbornly high.

Forecasts below show inflation likely to lose around one percentage point by the end of the year, and by the last quarter of 2009 to once again lie within the Reserve Bank's target range.

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Dec 08	Dec 09	Dec 10
Highest	4.2	2.8	2.8
Average	4.1	2.7	2.3
Lowest	4.0	2.6	1.7

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

Labour costs – wage pressures continue at historic highs – has the peak been reached?

Most recent outcome: +3.7% -- year-ended September 2008

The Labour Cost Index (LCI) recorded an increase of 3.7% in salary and wage rates (including overtime) for the September 2008 year. This is again the highest annual increase recorded since the series began in the December 1992 quarter. By comparison, the Quarterly Employment Survey (QES) average total hourly earnings increased 5.2% in the year to the September 2008 quarter.

In the LCI, salary and wage rates (including overtime) increased 1.1% in the September 2008 quarter. This followed rises of 0.8% in the June 2008 quarter and 0.9% in the September 2007 quarter.

When breaking down the data by public and private sector, both showed an increase of 1.1% for the September 2008 quarter. The main reason for the increase in wages was due to increases in the cost of living.

Despite these strong results, the general view by economist is that the peak is near as wage growth tends to be one of the last indicators to show a turn when the economy experiences a fundamental shift. Anecdotal evidence has tended to show that wage pressures have gone very cold very quickly, as security of jobs has instead become a more pressing matter. As workers become concerned about their job prospects for the short-medium term due to the full global impact on business operations, pressure to maintain wage parity by increasing costs reduces. Some employers who have commented that wage pressures have 'fallen off a cliff, but whether this will be a widespread phenomenon across the economy remains to be seen.

Forecasts below show that total labour cost inflation is expected to remain fairly consistent for both the 2008 and 2009 December quarters, dropping off slightly by the end of 2010.

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

	Years ending		
	Dec 08	Dec 09	Dec 10
Highest	3.4	4.1	3.7
Average	3.2	3.1	2.7
Lowest	3.0	2.7	1.9

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

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

Most recent outcome: +0.7% -- year-ended June 2008

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

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

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

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

Most forecasts are predicting the unemployment rate to continue to edge upwards, placing itself at around 5.5% by December next year as outlined below. Certainly, the PMI and PSI activity indicators as discussed above show employment activity continuing to trend downwards, with businesses looking to cut staffing levels as general business activity wanes.

Forecasts: Unemployment % (HLFS)

	Quarter		
	Dec 08	Dec 09	Dec 10
Highest	5.0	6.0	6.2
Average	4.7	5.5	5.4
Lowest	4.4	5.0	4.2

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

Interest Rates (90-day bill rate) – further movement downwards

Most recent outcome: 7.07% as at 30 October 2008

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

Unsurprisingly, the 90 day bill rate has fallen over 1 percentage point since the last business forecast. Forecasts below point to further reductions in interest rates to hit a low of around 5.7% by the December, then picking back up again by the end of 2010.

There is still continued talk in some circles that the Reserve Bank may make further significant cuts in the OCR over the next few months, with some now talking about the possibility of another 100 basis point cut. Although this would probably be more at the extreme end given current conditions (predictions of 50 basis points seems to be backed more), the previous 100 basis point cut was certainly not expected as of writing the September forecast. In the current climate, anything is possible.

Forecasts: Interest Rates (90 day bills)

	As at end of		
	Dec 08	Dec 09	Dec 10
Highest	6.8	6.3	6.8
Average	6.5	5.7	6.2
Lowest	6.3	5.0	5.0

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

Exchange Rates –

Most recent outcome:	NZD = US$0.572	as at October 29 2008
	NZD = AU$0.880	as at October 29 2008
	TWI = 58.2	as at October 29 2008

Market expectations are for the NZ dollar to continue to struggle against the currencies of our major trading partners over the next year or two. However, as mentioned above, the changes have been somewhat lumpy, with historic drops against the US$ but some improvement against the AUS$. Any predictions of the NZ$ in the short term are always fraught with difficulty, although major gains will probably be unlikely.

AUD (cents)			
	Dec 08	Dec 09	Dec 10
Highest	0.906	0.930	0.850
Average	0.866	0.859	0.824
Lowest	0.850	0.820	0.780

USD (cents)			
	Dec 08	Dec 09	Dec 10
Highest	0.620	0.620	0.660
Average	0.588	0.603	0.628
Lowest	0.550	0.560	0.560

TWI			
	Dec 08	Dec 09	Dec 10
Highest	60.5	62.8	65.3
Average	58.3	60.5	62.4
Lowest	55.1	58.1	56.9

Part 2: The Australian Economy

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

Like New Zealand, the Australian economy now faces some challenging times. Since mid-September, the commodity boom has well and truly ended with resource commodity prices falling by more than 35%. Their local share market has shedd value, and the Aus$ has suffered some extensive depreciation. In addition, retail sales have been well below trend, housing finance approvals have hit 13-year lows and the unemployment rate is rising. General forecasts see GDP growth slowing to around 1.75% in 2009 and staying soft at around 2% in 2010, although given current conditions, this could easily be revised down.

2.1 Economic Growth (GDP)

Most recent outcome: +2.7% for the year-ended June 2008.

Forecast 2008: +2.6

Source: *The Economist*

Australia's annual GDP continues to ease, now below 3%. Forecasts point to further drops, somewhere between 1-2% for 2009.

Some key recent economic statistics:

- Real retail sales up 3.2 per cent in August 2008 compared with August 2007.
- New motor vehicle sales down 8.1 per cent for August 2008 compared with August 2007.
- Dwelling unit approvals down 7.6 per cent for August 2008 compared to August 2007.
- Employment up 2.0 per cent for September 2008 compared to September 2007.
- Unemployment rate of 4.2 per cent as at September 2008 – down 0.1% from August 2007.
- Participation rate of 65.2 per cent as at September 2008, up from 65.1 per cent in August 2007.

The Australian PMI continues to show contraction at a similar rate to the New Zealand version, currently sitting at 47.2 as at September 2008.

2.2 Headline Inflation

Most recent outcome: +5.0 per cent for the year-ended September 2008

Forecasts: 2008: 4.2 per cent
Source: The Economist

After an initial decrease of 25 basis points in early September (the first decrease in the cash rate in Australia since December 2001), the credit crisis that hit later that month caused the Australian Reserve Bank Board to lower the cash rate by 100 basis points, decreasing the rate from 7% to 6%. Like New Zealand, inflation in Australia is likely to come back down from current levels around 5% to somewhere near the medium term target of 2-3% that the Board is aimed with targeting, so a drop in the cash rate of this magnitude is not expected to cause further inflationary pressures.

Part 3: Rest of the World

Internationally, markets are facing a significant period of strife and uncertainty. The credit crunch continues to flow through the developed world, causing share markets across the world to plummet, while bailout plans continue to be announced on an almost regular basis.

United States

In the United States, real GDP expanded at a 2.8% annualised rate in the second quarter of 2008. Compared with a broad stagnation in the previous two quarters, the acceleration in economic activity in the June quarter came mainly from the boost given by temporary fiscal stimulus measures to private consumption, solid net exports and a lessened drag from residential investment.

However, more recently available data points to a marked deceleration in the economy in the September quarter, as labour markets have deteriorated; foreign demand has slowed, with commodity prices remaining at elevated levels. In addition, financial market strains increased substantially in September. The collapse of several financial institutions has posed significant risks for the availability of credit and increased uncertainty for the economic outlook. Ongoing initiatives by the US authorities to restore confidence in the financial system should alleviate some of the associated risks. However, the implementation of such measures implies a deteriorating fiscal position over the near term.

The US Federal Open Market Committee decided to lower the target for the federal funds rate 50 basis points to 1%. This was due to the view that the pace of economic activity appeared to have decreased markedly, owing to a decline in consumer expenditure, business equipment spending and industrial production. Also, slowing economic activity in many other countries had dampened prospects for US exports.

Euro

In the United Kingdom, the quarterly rate of output growth continued to slow down, standing at 0% in the second quarter, well below the long-term average (0.7%). Confidence indicators also followed a downward trend in general and have remained below long-term averages in recent quarters. House prices have declined in recent months, falling in August by around 10% and 13% year on year according to the Nationwide and Halifax indices respectively. In line with falling house prices, in the second quarter of 2008 output in construction contracted by 1.1% quarter on quarter. Annual HICP inflation rose to 4.7% in August, from 4.4% in July, reflecting a broad-based increase across HICP components. The Bank of England expects inflation to increase further in the second half of 2008.

In most of the other large EU countries outside the euro area, GDP growth was fairly stable in the second quarter of 2008, and inflation developments were mixed in August. In Sweden, quarterly growth has continued to slow down, standing at 0.0% in the second quarter of 2008 (well below the long-term average of 0.8%).

Japan

In Japan, economic activity has declined significantly, reflecting sluggish domestic demand and a slowdown in exports. In the second quarter of 2008, according to the second preliminary estimate by the Cabinet Office, real GDP decreased by 0.7% on a quarterly basis, largely offsetting the fairly strong growth recorded in the first quarter of 2008 (0.7% quarter on quarter).

The contraction in activity in the second quarter of 2008 was broadly based across GDP components. Private consumption decreased by 0.5% over the quarter, subsequent to an increase of 0.7% in the first quarter, reflecting subdued real income growth and deteriorating labour market conditions.

With exports and imports falling substantially (by -2.5% and -2.6% quarter on quarter respectively), the contribution of net external demand to GDP declined to -0.1 percentage point from 0.4 percentage point in the previous quarter.

Forecasts: World GDP Growth (Selected Trading Partners)

Country	*Latest*	*2008*	*2009*
Australia	2.7	2.6	2.3
Canada	0.7	0.8	1.4
Japan	0.7	0.7	0.6
United Kingdom	1.5	1.1	0.1
United States	2.1	1.6	0.6
Euro Area	1.4	1.2	0.6

Source: Economist

Forecasts: World Consumer Price Inflation (Selected Trading Partners)

Country	*2008*
Australia	4.5
Canada	3.5
Japan	2.1
United Kingdom	5.2
United States	5.4
Euro Area	3.6

Source: Economist