BusinessNZ
BUSINESS NZ PLANNING FORECAST
planning FORECAST

Business Planning Forecast - June 2008

Executive summary – further downward trends but debatable whether the 'R' word will eventuate

Economy

Recession: a word that has come out in the open in recent weeks. It has been a fairly long time since serious thoughts about New Zealand going into a recession have hit the headlines but various data coming out since our last Business Planning Forecast certainly point to a significant slowing of the economy. However, it is also easy to get sucked in by the doom and gloom and think that a recession is inevitable. This is far from the case. To use an analogy, just because a boat takes on more water, it does not mean it is going to sink. The New Zealand economy is still in relatively good shape and should be able to weather the flow-on effects associated with recent global financial market jitters. Indicators show that the economy has benefited from higher international commodity prices through strong global demand, although households are tending to be more circumspect with their spending, while exporters are hoping that the easing of the NZ$ continues.

Business and consumer confidence continues to be at the wrong end of the spectrum, with business confidence especially weak. The concern here is that not only is the business view of the general economy negative, but business's own activity has, on balance, been negative for the second consecutive time.

Consumer confidence has also taken a plunge (worst in a decade). This has flow-on effects to all those items that consumers love to purchase, as the first reaction is to cut spending, and with that either save or pay off debt. Cuts in spending usually have their first effects on big ticket items (think plasma TVs) and smaller discretionary items. This will mean some areas of retailing will be hit more than others.

A healthy labour market and tax cuts proposed in the 2008 Budget may offset some of the added costs facing households as a result of higher international fuel prices and increased food costs, the recently announced delay in the introduction of additional fuel costs as part of the climate change agenda will also keen to alleviate future concerns.

About the Business Planning Forecast Report

This bulletin is designed to help your business planning. It brings together forecasts of important indicators to help you prepare budgets and business plans. The forecasts are drawn from two main sources. The New Zealand information is based on a survey of the five main trading banks (ANZ-National, ASB, BNZ and Westpac). Australian information is based on consensus forecasts compiled by the UK Economist. Sources of other information are as shown. Where appropriate, averages are included alongside the highest and the lowest forecasts, giving an idea of the spread of forecasts and therefore of the uncertainty involved. The information in this report is of a general nature; your firm is unique, and you will need to make your own decisions. However, the better informed you are about the way various business people see the future, the better the decisions you can make.

HIGHLIGHTS

Inflationary pressures will continue to be around for some time to come, despite a weakening housing market.

Interest rates in NZ will remain high as the Reserve Bank attempts to contain inflation, although some relief may be closer than thought. While Australia's official rate gets closer to ours, others have fallen away as they try to combat recessionary possibilities.

World commodity prices have continued at historically high levels, but NZ exporters have not benefited as much as they should from strong commodity price growth over the last 2-3 years because of the persistently high NZ dollar.

An increase in the number unemployed, along with a contracting total labour force has resulted in the unemployment rate increasing, which will most likely continue in the months ahead.

Part 1: The New Zealand Economy

1.1. Economic growth (GDP) – higher than expected

Most recent outcome: 3.1% for the year to December 2007

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 over 3%, indicating a relatively strongly performing economy with higher growth than in many other developed countries. However, growth prospects have taken a hit on the back of a slowing international economy, with expectations for growth dropping in 2008/09, as indicated below.

Official data shows that economic activity grew strongly in the last quarter of 2007 expanding by 1.0 percent (higher than market expectations of around 0.8 percent) and taking calendar year growth to 3.1 percent.

Growth was consistent across the economy, driven in particular by primary production (underpinned by strong dairy prices). Assistance also came from manufacturing, with finance and business services making significant contributions to growth as well.

Perhaps of significance, business investment was strong with increases recorded in non-residential buildings (up 16.4 percent), plant, machinery and transport (up 4.0 percent) and intangibles (up 10.8 percent). Intangibles are non-physical assets such as software and mining rights. Increases in intangibles were driven largely as a result of increased exploration activity. On the other hand, private consumption has remained subdued (up 0.5 percent) as has public consumption (up 0.4 percent).

Looking forward, agricultural production is likely to take a hit for the March and June 2008 quarters as stock would have been sent to slaughter earlier (including some capital stock) as a result of the ongoing drought and this will reduce output over the coming year. On the other side of the coin, the drought (which has been estimated by MAF to reduce incomes by over $1 billion this year, has been well and truly offset by an injection of around $3 billion in increased milk payouts to dairy farmers. Many of Fonterra's farmers are still predicting a higher final payout (likely to be around $7.30-$7.50 per kg) despite the consistent higher value of the NZ dollar against the US.

Business and financial services are also likely to take a hit over the March and June quarters of 2008 as the slowdown in the housing market flows through. It is quite eerie the extent to which the housing market impacts on consumer sentiment with rises over the last few years fuelling a spending binge but with consumption declining as soon as prices drop (around 5% over the past 6 months).

Despite these negative forces, growth for the March and June quarters will probably be positive, but at a lower level than previously forecast.

The trade balance for March 2008 was a somewhat surprising deficit of $50 million, only the second time in the past 10 years that the March month has not shown a surplus. For the March 2008 year the trade balance was a deficit of $4.5 billion, the smallest March annual deficit since 2004.

Although dairy product exports were again a big contributor to overall exports, lower prices and volumes (the latter being drought-related) contributed to weaker than expected exports for March. In addition, lower oil prices, as the peak of the Tui oil production has passed, also accounted for the weaker than expected export values.

Expectations are that GDP will take a significant hit in terms of growth by mid way through 2009 (averaging only 0.9%). Expectations going into 2010 are spread to say the least. While the average result shows a recovery to 2.5%, there is a stark contrast between the highest (4.3%) and lowest (0.8%) results. This perhaps indicates that picking growth two years out during current uncertain times is difficult at best, as the economy takes a turn that has become somewhat unfamiliar over recent years.

Forecasts: Real GDP % Growth

	Years Ending		
	Jun 08	Jun 09	Jun 10
Highest	2.8	1.3	4.3
Average	2.8	0.9	2.5
Lowest	2.7	0.6	0.8

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

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

Interest rates – one word can make all the difference

New Zealand's Official Cash Rate (OCR) is still very high by international standards, although there is the possibility that some easing may be on the cards in 2008. In tandem with continued inflationary pressures, New Zealanders' strong tendency to fund consumption out of debt also puts upward pressure on interest rates as international financiers want a reasonable return on their funds to compensate for the perceived increased risk of investing in New Zealand.

The extent of NZ's external imbalance leaves the country vulnerable as international investors are re-pricing risk and credit is becoming internationally more expensive in light of recent events. NZ's large external deficit leaves it susceptible to a change in investor sentiment since the country relies heavily on external funding for its investment needs.

Since the previous Business Planning Forecast, the USA Federal Reserve has slashed interest rates a number of times in reaction to a slowing economy in the near term, reflecting the intensification of the housing correction and reduced consumer confidence. In addition, other countries have also cut their rates, although not to the extreme level seen in the US. As mentioned in the previous Business Forecast release, the upshot is that New Zealand interest rates now look much more attractive to investors, as one of our competitors for funds investment falls back. However, New Zealand's closest economic neighbour also has inflation concerns to worry about, which has led the Australian Reserve Bank to lift interest rates again, reducing the differential between Australia and New Zealand to only 1 percentage point.

In New Zealand, the omission of one word in the official OCR announcement caused a stir, and changed many peoples perception of when a cut in the OCR will occur. The Reserve Bank believed that economic activity had weakened more markedly than expected, and there have been sharp falls in consumer and business sentiment, exacerbated by tighter credit conditions, a further decline in the housing market and weaker prospects for world growth.

However, the Bank is still concerned about inflationary issues, both current and coming up, stating that *"the labour market is still strong and New Zealand's key international commodity prices remain high. Government spending plans and the possibility of personal tax cuts can also be expected to limit the economic slowdown".*

The last statement of the announcement was where most interest by economists and the media was concentrated. The Bank stated that overall, *"given this outlook, we expect that the OCR will need to remain at current levels for a time yet to ensure inflation outcomes of 1 to 3 percent on average over the medium term"*. This was a step down from the March statement which noted rates at current levels *"for a significant time yet".*

Official Interest rates

Central Bank	Current rate (%)	Previous rate (%)
Reserve Bank of Australia	7.25%	7.00%
US Federal Reserve	2.25%	3.00%
Bank of England	5.00%	5.25%
European Central Bank	4.00%	3.70%
Reserve Bank of NZ	8.25%	8.00%

The upshot of this is that looking forward, the general consensus now is that New Zealand's OCR has certainly reached its peak, and a rate decrease is more likely sometime during the later half of 2008, rather than early 2009 as previously thought. However, the Bank will have to be careful that there is not a strong run against the NZ dollar, which until now has helped keep a lid on inflation.

The New Zealand Dollar – signs point to easing

Most expect easing of the New Zealand dollar against most major currencies over 2008. However, how fast and by how much is difficult to establish at best.

Since the last Business Planning Forecast, the New Zealand dollar has tended to ease but overall has generally remained within the 70-72 cent mark on a Trade-weighted Index (TWI) basis. Likewise, similar easing has been evident against the pound and the US dollar, although the latter has been coming off historic highs. The cuts in interest rates in those countries, coupled with the persistently high interest rate level in New Zealand means investors will always flock to where the greatest gains can be made. By contrast, Australia's similar inflationary problem has meant the New Zealand dollar has dropped roughly 4c since the previous forecast edition.

The significant number of bad news stories, either via official statistics or by elements of the media who seem somewhat obsessed with anything showing a downwards movement has also caused the NZ dollar to be less attractive, as any considered investment in a country is obviously more than just about interest rates.

Net migration flows – the slowdown continues

Over the last few years relatively large migration inflows, on average, have boosted domestic consumer spending, car sales and house building. Migration has also helped mitigate some of the pressures building up in the labour market. However, this is now drying up rapidly, creating further supply-side labour shortages.

The annual net migration gain peaked at +42,500 for the year ended June 2003, fell as low as a +6,000 gain for the year ended October 2005 and then regained some momentum in 2006 to reach an annual gain of 14,800 by November 2006. However, since early last year net migration figures have drifted downwards (to 4,700 for the year ending March 2008), with slowing net migration largely due to a rise in the number of permanent and long-term departures, particularly to Australia. In the year ended March 2008 there was a net PLT outflow of 29,900 to Australia, compared with 23,300 for the same time last year. This takes the net outflow to Australia to its highest level for a March year since 2001 (when it was 31,800).

The continued reduction in the net inflow of migrants is having a two-fold effect. On the positive side, it continues to take pressure off housing demand which will be welcomed by the Reserve Bank. However, one could argue that this inflation dragon appears well and truly slayed as recent housing statistics have shown quite negative results, which are likely to continue through the winter months. On the other hand, the decrease in migrant numbers means less skill capacity in New Zealand and upward pressure on wages, given limited flexibility to provide more labour.

Commodity prices – crunch time

The ANZ World Commodity Price Index peaked again in March (218.3), before easing slightly in April (217.7). Over the year, the April 2008 result was 20.7% higher than April 2007, as well as the April 2007 result being 20.9% higher than April 2006 The strength of international dairy prices over the last couple of years has largely underpinned the significant rise in the World Commodity Price Index over the same period, although the index is expected to decline over coming months in light of increased international uncertainty and reduced growth prospects. However, it is important to realise that the commodity boom is destined to peak at some stage following the huge and unsustained rises experienced over the last couple of years.

When converted into NZ dollars, the ANZ NZ Dollar Commodity Price Index went up in the month of March (up 2.1%) and April (up 1.1%). This largely reflects the impact of a generally decreasing $NZ against our major trading partners of late. On an annual basis commodity prices, when converted into $NZ, were up 13.4%.

While NZ dairy farmers are now reaping the rewards of higher international prices in respect to milk pay-outs, the continued recovery from drought in some parts of the country may well see overall returns not as favourable as first expected given continued downward pressure on production as a result of feed shortages.

	World Price Index	Monthly % Change	Annual % Change	NZ$ Index	Monthly % Change	Annual % Change
April 2003	119.6	-1.2	3.6	112.9	-0.8	-14.5
April 2004	140.9	2.7	17.8	117.7	5.7	4.3
April 2005	156.6	0.0	11.1	117.3	1.6	-0.3
April 2006	149.2	1.6	-4.7	128.1	3.9	9.2
April 2007	180.4	4.9	20.9	133.9	-0.1	4.5
April 2008	217.7	-0.3	20.7	151.8	1.1	13.4

Source: ANZ Commodity Price Index NZ – 5 May 2008

Business confidence – not that confident

Both business and consumer confidence surveys have dropped with a thud over recent months. Perhaps of more significance, while previous months have shown businesses to be pessimistic about the general economy, perceptions of their own business activity have generally been positive. This has now changed. Business views on the general economy and their own personal business situation have both deteriorated.

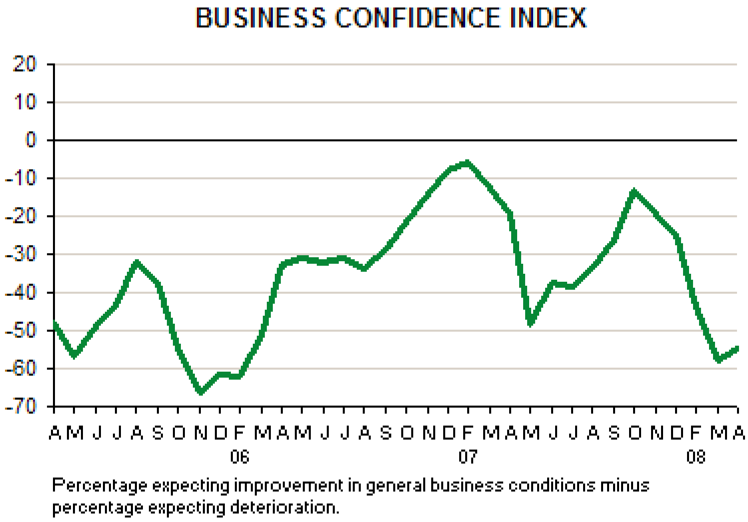
Similarly, consumer confidence has turned sharply down. On the upside, the labour market is still at close to full capacity while household income growth has been relatively strong and underpinned by the perceived wealth effect of increasing house prices – until recently. This has now changed with housing prices dropping around 5% over the past six months and now at similar levels to a year ago. Further on the downside, increasing costs associated with major expenditure items (food and petrol) will dampen consumer enthusiasm for spending for the coming year while higher interest rates will squeeze the household budget still further.

Proposed tax cuts in this year's Budget (timing and scale seem to change almost on a weekly basis) may give consumers a shot in the arm but for many, such cuts will likely compensate only for added cost pressures over the last few years and will not offset increased debt servicing costs (as a result of higher debt levels) or the potential flow-on costs associated with the Government's Emissions Trading Scheme.

The National Bank's business outlook shows that business confidence dropped with a thud in March 2008 (see graph below). A net 58% of businesses expected business conditions to deteriorate over the coming year, but picked up slightly to 55% for April. Confidence is generally weaker across all the five major subgroups: retailing, manufacturing, agriculture, construction and services.

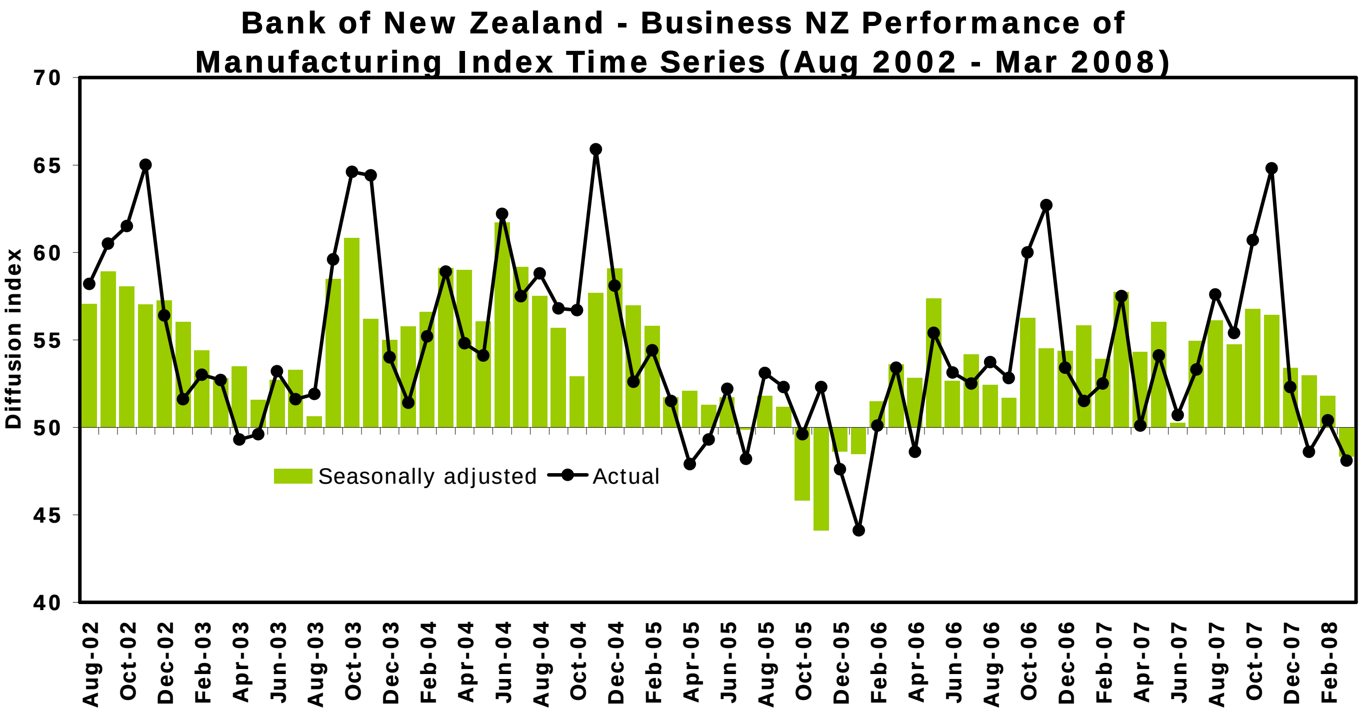
Perhaps much more importantly, as mentioned earlier, is the fact that firms' expectations towards their own businesses were negative for March and April (-6 and -4 respectively. This was the first time this indicator had not been positive since early 2006. While these figures might not seem to be particularly concerning, negative expectations for a firm's own business activity are very rare. In fact, negative results have only been recorded 12 times in the 20-year history of the survey – with five of these being at the start of the survey in 1988, immediately after the sharemarket crash of 1987.

Increased pessimism is likely to be seen positively by the Reserve Bank in terms of inflationary expectations, with the potential for earlier interest rate cuts than previously contemplated. The fly in the ointment from the latest business confidence survey is that inflationary expectations (including business expectations of raising prices) have increased, not fallen as one would have expected.



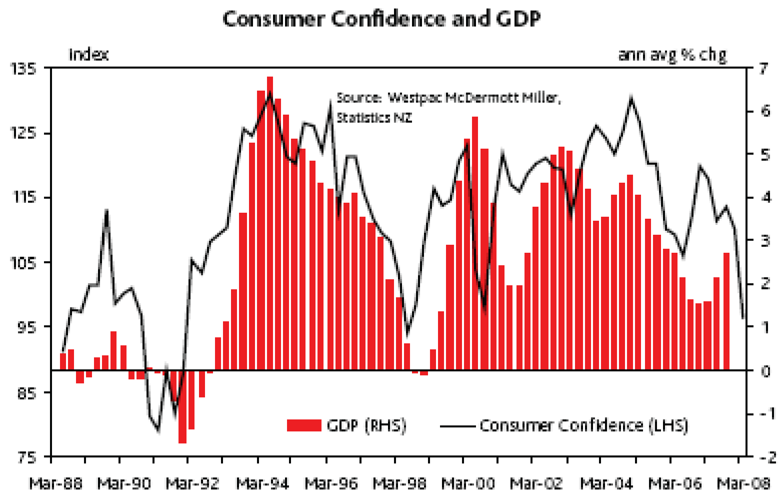
A drift downwards in business confidence is indicated by the recent results of the Bank of New Zealand - Business NZ Performance of Manufacturing Index (PMI) and Performance of Service Index (PSI). As the graph below shows, unadjusted activity for the manufacturing sector was in decline for two of the last three months. However, of increased concern is the first decline in the seasonally adjusted result since January 2006 and the lowest value since November 2005.

Although the PSI is still a relatively new survey, and as yet not able to provide exact year on year comparisons (nor seasonally adjusted results), activity in the services sector has generally been lacklustre for the first quarter of 2008, with values of 51.9, 55.6 and 50.8 respectively. The value for March (50.8) was the lowest recorded, and comments from respondents continued to focus on negative sentiments, with various comments centered on customers/clients and other businesses spending less. Other comments related to rising costs and current interest rate levels.



Consumer confidence – lowest in a decade

Westpac's Consumer confidence index dropped from 110.0 in the December quarter 2007 to 96.5 in March 2008, the lowest level recorded for a decade (see graph below). An index number over 100 indicates there are more optimists than pessimists, while a number below 100 indicates that pessimists outnumber optimists. Like measures of business confidence, it is relatively rare that consumer confidence goes into negative territory (i.e. a measure below 100).



While job security is reasonably good and income growth has been strong, these have been offset to some degree by costs rise in the three significant but basic elements of living – food, housing (servicing) and transport. All three have been on the rise over recent times, putting a strain on many household budgets burdened through high levels of debt.

Perhaps the most interesting point for the survey came from respondents' views of their own financial circumstances. When asked if they felt better or worse off financially than a year ago, an increased number said they felt worse off. Given that the major increases in costs facing consumers have largely already been felt over previous quarters, it might not be unreasonable to assume that the latest fall has much more to do with the housing market, and the fact that recent declines in prices are impacting on the psychology of consumers. In short, when the housing market was booming, consumers spent up large despite the fact that they only had mere paper equity in their housing investment, and still had to live somewhere.

When housing prices drop, people cut back on consumption, and have a much more negative outlook despite there being little evidence of a major slowdown in employment prospects or any significant rise in forecast unemployment. The danger, as mentioned earlier, is that any talk of a recession might become a self-fulfilling prophecy as people look to reinforce any negative news rather than continue to focus on the big picture. This is reinforced by a bias in the media of late over-emphasising negative sentiment rather than objectively looking at the facts.

As has been mentioned in the past, the big issue facing households in New Zealand is rising debt levels, and the ability to service that debt. To date, debt servicing has not really been a problem but any faltering of the labour market will increase financial pressures. With high levels of debt it is simply not a case of "downsizing". Instead households open themselves up to large financial losses as investors are not exactly queuing up to purchase properties as they come on the market. This has not been assisted by the reduction in net migration which has now slowed to a trickle.

Household debt levels are currently sitting at 164 per cent of disposable income and debt servicing costs are 14.5 per cent of disposable income largely as a result of previous hikes in interest rates by the Reserve Bank flowing through to most households and the repricing of credit risk on international markets, which is flowing through to households and businesses alike.

According to the REINZ Housing Market Report (February 2008), the median house price fell by $3,500 to $337,500 in February 2008 compared to the preceding month. Perhaps more critical for future house prices, the number of house sales was down 32.1 (year on year) to February 2008. This would suggest that there is a build up of housing stock which will only require a down-turn in employment prospects or further interest rate rises (both of which are not totally out of the question) to put the skids under the housing market.

Overall, the Reserve Bank will be reasonably pleased with the current state of the housing market. The inflationary pressures evident in the market over the last 2-3 years have finally abated with prices down 4.3 percent since September last year and now only 0.75 percent higher than a year ago. While there are other inflationary pressures of concern to the RB, they are largely beyond the scope of monetary policy to influence e.g. international oil and food prices and the government's expansionary fiscal policy.

Other areas of consumer behaviour show that consumer confidence, while down, is certainly not out.

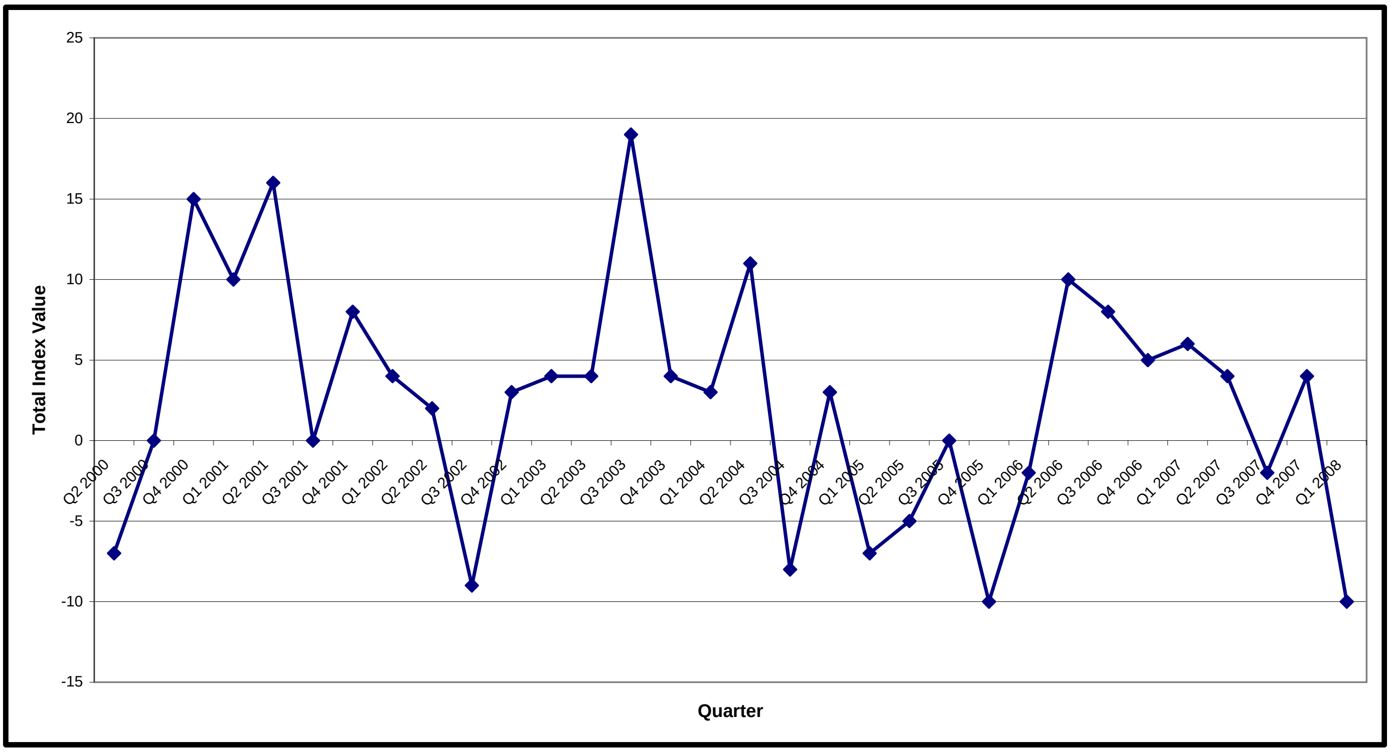
The trend for retail sales, while fluctuating on a monthly basis, is basically flat at present. In terms of housing activity, both the number of new dwellings and the value of residential buildings continue to trend down although non-residential activity continues to show solid growth.

Consumer confidence is likely to be boosted later this year when the Government announces the nature of its personal tax reduction package in next month's Budget.

Putting it all together – continuing the downwards trend

The graph below shows the trend of the main economic factors that are converted into an overall index, taking into account economic growth/performance indicators, monetary policy/pricing indicators, business/consumer confidence indicators and labour market indicators. The overall Business NZ Economic Conditions Index sits at -10, down 14 on the previous quarter and down 16 on a year ago. It is currently at its equal lowest level since recording of the index began.

Business NZ Overall Economic Conditions Index



1.2 Inflation – strong pressures persist

Most recent outcome: +3.4% year-ended March 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 March quarter 2008 CPI rose 0.7% on the December quarter, bringing headline annual inflation to 3.4% - again outside the Reserve Bank's target range of 1-3%. The Reserve Bank is picking inflationary pressures to remain strong with headline inflation expected to remain above 3% for 2008. However, the headline rate for the March quarter was slightly weaker than the market had predicted, although mostly in line with the reserve bank's predictions.

The main drivers of the increases for the March quarter were food (up 1.8%), housing and household utilities (up 1.0%) and transport (up 0.8%).

An increase for the food group came from higher prices for grocery food (up 3.6%), restaurant meals and ready-to-eat food (up 1.3%) and non-alcoholic beverages (up 3.3%) subgroups. Within the grocery food subgroup the main contributors to the 3.6% increase were higher prices for cheese (up 18.9%), bread (up 7.3%) and butter (up 33.9%).

Prices for the housing and household utilities group were mainly influenced by actual rentals for housing rising 1.2% in the March 2008 quarter, following rises of 0.5% and 0.8% in the December 2007 and September 2007 quarters, while prices for the purchase of new housing increased 0.9%. In addition, prices for electricity rose 0.8%.

The increase in the transport group was mainly due to price increases for petrol (up 4%). Interestingly, if petrol prices had remained constant from the December 2007 quarter to the March 2008 quarter, the CPI would have increased 0.5%. Purchasing of second-hand motor cars (up 1.3%) also made a significant upward contribution to the transport group.

The non-tradable component increased 1.1%, following an increase of 0.7% in the December 2007 quarter. Significant upward contributions came from actual rentals for housing, and from cigarettes and tobacco. The most significant downward contribution came from domestic air transport.

The tradable component increased 0.2%, following an increase of 1.8% in the December 2007 quarter. The most significant contributions to the tradable component came from petrol and (tradable) grocery food. The tradable component would have fallen 0.3% if petrol prices had remained constant over the same period. Offsetting these increases were downward contributions from international air transport and overseas package holidays.

Notwithstanding short-term variations in the CPI components, the continued strength of non-tradables inflation reinforces the need to ensure that the economy is as competitive as possible by removing the monopoly provision of some goods and services, currently provided by the Government or its various agencies.

Forecasts below show inflation likely to remain around the very top end of the inflationary band, obviously leaving almost no leeway for any shocks.

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Jun 08	Jun 09	Jun 10
Highest	3.5	3.3	3.7
Average	3.4	3.0	2.8
Lowest	3.3	2.4	2.3

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

1.3 Labour costs – wage pressures continue at historic highs

Most recent outcome: +3.4% -- year-ended March 2008

As to be expected in a tight labour market, continued wage pressures are causing skill shortages in a number of industries and regions, pushing up average labour costs as a result. To a certain extent these costs are flowing through into general wage pressures across the economy as a whole.

The Labour Cost Index (LCI) recorded another increase of 3.4% in salary and wage rates (including overtime) in the year to the March 2008 quarter. This is the joint highest annual increase since the series began in the December 1992 quarter, with the December 2007 quarter also showing a 3.4% increase. Salary and wage rates recorded an increase of 3.5% and 3.3% for the private and public sectors, respectively.

An alternative measure of labour costs is the Quarterly Employment Survey (QES). This tends to be much more volatile than the Labour Cost Index, mainly because it reflects compositional changes in the labour force. As with the LCI, the QES also shows significant wage and salary pressures across the board with a quarterly rise of 1.1% and an annual rise of 4.3% for the year to March 2008.

Forecasts below continue to show stronger wage inflation in the short-medium term, although with the possibility of some pressure easing by 2009/10. Although the most recent unemployment rate showed an increase, many businesses are sometimes still having trouble getting anybody on the factory floor, meaning the prospect of further wage pressures will continue to loom for some time to come. A slowdown in net migration is fuelling the current labour shortage.

Forecasts: Labour Cost Index % Change

	Years Ending		
	Jun 08	Jun 09	Jun 10
Highest	4.1	3.3	2.8
Average	3.8	3.1	2.6
Lowest	3.4	3.0	2.4

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

1.4 Employment – a turn in the road?

Most recent outcome: -0.1% -- year-ended March 2008

Given the weight of negative results across various indicators, it was no surprise that employment took a hit in the March quarter. However, it remains to be seen whether the fall itself was a real fall or a correction from the previous result.

Numbers employed during the March quarter decreased by 29,000 to 2,141,000. This was a 1.3% fall over the quarter, but only a -0.2% fall over the year. Both full-time and part-time employment fell but the decrease was stronger with full-time employment, with female full-time employment decreasing 22,000. However, this followed an increase of 31,000 for the December, so there may be some correction of results evident here.

Notwithstanding the possibility of the results realigning somewhat, the percentage fall in employment was the largest since March

1989. In addition, the number of unemployed people increased over the quarter, while the total labour force contracted, resulting in an increase in the unemployment rate of 0.2 percentage points, to 3.6%. In addition, job losses were in sectors most expected, such as wholesale/retail and the business/financial service areas. The New Zealand unemployment rate is still very low by OECD standards, but further worsening economic conditions over the next 6 months may see that figure continuing to climb. The June result will probably give a better indication of the true extent of the slowdown.

The average result forecast for June 2008 has already been reached in March. Most predict the unemployment rate to continue to edge upwards, placing itself at over 4% by June 2009.

Forecasts: Unemployment % (HLFS)

	Years Ending		
	Jun 08	Jun 09	Jun 10
Highest	3.8	4.6	4.7
Average	3.6	4.2	4.2
Lowest	3.4	3.8	3.6

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

1.5 Interest Rates (90-day bill rate) – slight easing

Most recent outcome: 8.70% as at 9 May, 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 they may be at variance if the market prices in future increases or decreases in the OCR).

The impact of higher interest rates on households is now showing signs of being significant, with floating rates well over the 10% rate (some banks at almost 11%), and short term fixed rates close to 10%. Given the increase in official interest rates is (probably) at its peak, there is no real justification for people to enter into longer term mortgage rates, and the 1 or 2 year options are the most popular. Still, at that level with total household debt continuing to rise, hefty mortgage repayments will, over the next few years for many consumers, leave little room for consumption elsewhere.

The forecasts below point to reductions in interest rates by 2009, although this is not a foregone conclusion. There is still the possibility of interest rates remaining high for some time.

Forecasts: Interest Rates (90 day bills)

	As at End of		
	Jun 08	Jun 09	Jun 10
Highest	8.9	8.2	7.7
Average	8.8	7.4	6.5
Lowest	8.8	6.6	5.7

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

1.6 Exchange Rates – tipping downwards?

Most recent outcome: *NZD = US$0.776 as at 8 May 2008*
NZD = AU$0.826 as at 8 May 2008
TWI = 69.7 as at 8 May 2008

The TWI still lies just below the 70-mark, while the NZ$ against the US$ continues to show slight easing, along with a downwards trend in the Aus dollar.

The NZ dollar continues to be overvalued with some commentators suggesting it is around 10-20% above its long-term trend.

As mentioned elsewhere in this forecast, the slashes of official rates in the US has continued to keep the NZ$ high against the US$, but over the medium-long term, demand for currency is predicated more towards economic growth, which has not been a selling point for the New Zealand economy in recent months. This has seen the NZ$ slide against most other currencies, and the chances are the TWI will continue to remain below 70.

Market expectations are for the NZ dollar to struggle against the currencies of our major trading partners over the next year or two. However, this will very much depend on New Zealand's economic growth and, particularly inflation – the factor that has resulted in significantly higher interest rates in NZ and the rest of the world, and to some extent has underpinned the NZ dollar.

The current uncertainty surrounding global growth prospects and their implications for NZ is reflected in the wide range of forecasts for the NZ dollar over the next couple of years. While expectations are for a significant drop over time, when and by how much are certainly the subject of much debate. Clearly with changing global circumstances, forecasting exchange rates is fraught with difficultly.

AUD (cents)			
	Jun 08	Jun 09	Jun 10
Highest	0.85	0.82	0.85
Average	0.84	0.80	0.81
Lowest	0.83	0.76	0.78

USD (cents)			
	Jun 08	Jun 09	Jun 10
Highest	0.82	0.78	0.72
Average	0.79	0.70	0.65
Lowest	0.78	0.64	0.59

TWI			
	Jun 08	Jun 09	Jun 10
Highest	72.5	68.0	66.4
Average	70.3	65.3	64.1
Lowest	69.5	60.9	61.0

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.

While the current Government will continue with considerable income tax cuts in 2008-10 to fulfil its election pledges, the budget should remain in surplus due to robust GDP growth and efforts to contain spending.

Annual GDP growth is expected to average 2.6% in 2008-12, however this will be down from an average of 3.3% in 2003-07. Domestic demand will remain the main engine of growth, but despite high employment levels, pension reforms etc, private consumption growth is likely to moderate as households move to reduce their high levels of debt.

Inflationary pressures persist, with capacity utilisation rates still high and the labour market remaining tight. Inflation is expected to be above the 2-3% range targeted by the Reserve Bank of Australia (the central bank) in 2008 and 2009. The Australian dollar is forecast to depreciate against the US dollar in 2009-12, owing to falling interest rates and weakening world commodity prices.

Currently, the main downside risks on GDP growth in Australia are the following:

- a greater than expected fall in international commodity prices
- a drop in housing prices
- continued turmoil in global financial markets
- a larger than projected rise in inflation; and
- a continuation of the drought, which is harming agricultural output.

Overall, this paints a similar picture to New Zealand, even including the issue of drought given the negative side effects on New Zealand's agricultural production and energy supply capacity.

2.1 Economic Growth (GDP)

Most recent outcome: +3.9% for the year-ended Dec 2007.

Forecast 2008: +3.3
Source: *The Economist*

Australia's annual GDP continues to ease, with forecasts pointing to growth coming down to around 3.5% by 2008/09.

Some key recent economic statistics:

- Real retail sales up 6.5% in February 2008 compared with February 2007.
- New motor vehicle sales up 5.2% for March 2008 compared with March 2007.
- Dwelling unit approvals up 7.9% for February 2008 compared to February 2007.
- Employment up 2.7% for March 2008 compared to March 2007.
- Unemployment rate of 4.0% as at March 2008 – down from 4.3% in February 2007.
- Participation rate of 65.2% as at March 2008 – up from 64.9% in March 2007.

The Australian PMI results for the first quarter show that Australian manufacturing is stagnant at best with results of 49.2, 51.4 and 51.2 respectively. This follows 19 consecutive months of growth, with performance in early 2008 being affected by uncertainty about the outlook of the global economy, rising input costs and higher interest rates. The Australian PSI displayed values of 54.9, 53.2 and 53.8 for the first three months of 2008, showing more resilience than the PMI, and ending the quarter on a stronger note after two consecutive months of easing activity.

2.2 Headline Inflation

Most recent outcome: +4.2% for the year-ended March 2008

Forecasts: Mid 2008: 3.1%
Source: *The Economist*

After holding interest rates at 5.25% for a long period, the Reserve Bank of Australia has now lifted the cash rate twice in 2008 alone to sit at 7.25% (1 percentage differential with NZ) with further rises possible (although the most recent OCR announcement saw no change).

The increases were made in order to contain and reduce inflation over the medium term, as inflation was high in 2007 and continuing to grow in 2008. However, there's expected to be further moderating into 2008 in response to slower growth in demand.

Given the average Australian householder's exposure to floating interest rates for their mortgage as stated above, there may well be a reduction in consumption as household budgets are squeezed. Nevertheless, like New Zealand, employment growth is still strong with record low unemployment, factors likely to fuel continued domestic consumption for some time.

Part 3: Rest of the World

Both the weakness of US economic activity and high financial market volatility are having a dampening effect on the pace of global economic expansion. However, global economic activity still continues to be supported by the resilience of economic growth in emerging markets, particularly in Asia. Survey evidence in February indicated that global economic activity might decelerate further in the coming months, owing mainly to a further weakening of manufacturing sector activity. Headline consumer price inflation in OECD countries remains at high levels as a result of continuing upward pressures on commodity prices. For the OECD countries, the annual rate of change of the CPI was 3.4% in February, which was 3.5% in January, while the CPI excluding food and energy remained unchanged at an annual rate of 2.0%. Figures concerning global input prices suggest that cost pressures remain high, particularly in the manufacturing sector.

United States

While most of the headlines coming out of the US seem to involve presidential candidates at the moment, equally important is the state of the US economy, as it continues to lose ground.

In mid March, the Federal Open Market Committee decided to lower its target for the federal funds rate a significant 75 basis points to 2.25%. The reason for this was that information indicated that the outlook for economic activity had weakened further. Growth in consumer spending had slowed and labour markets had softened. In addition, financial markets remained under considerable stress and the tightening of credit conditions and the deepening of the housing contraction would likely weigh on economic growth over the middle quarters of 2008.

Inflation has been elevated, and some indicators of inflation expectations have risen. While the Committee expects inflation to moderate in coming quarters, reflecting a projected leveling-out of energy and other commodity prices and an easing of pressures on resource utilization, uncertainty about the inflation outlook has increased.

The US dollar remains sluggish, and is expected to remain weak against most major currencies in the second and third quarters of this year and to start to firm in the fourth.

Real GDP is forecast to grow by just 0.8% in 2008 and recover modestly to 1.4% in 2009. Many expect the US to experience a recession this year and that the US housing market will remain weak over the forecast period.

Further north, the Bank of Canada lowered its benchmark interest rate from 3.5% to 3% at its meeting on April 22nd, the third time it has cut rates this year. The central bank said it expected a "*deeper and more protracted slowdown"* in America to hurt Canadian exports and tighter credit conditions to damp spending at home. Canada's inflation is below 1.5% and the bank reckons "some further monetary stimulus" will be necessary to meet the 1-3% target over the medium term.

Euro

Overall Euro GDP growth stood at 2.2% for the December 2007 year.

At its meeting in April, the Governing Council of the European Central Bank (ECB) decided to leave the key ECB interest rates unchanged, with the latest information confirming the existence of strong short-term upward pressure on inflation. In fact, the euro area is experiencing a rather protracted period of temporarily high annual rates of inflation, resulting mainly from increases in energy and food prices.

The general economic climate of the euro area is sound, with macro data continuing to point to moderate but ongoing real GDP growth. However, the level of uncertainty resulting from the turmoil in financial markets remains unusually high and tensions may last longer than initially expected.

In the United Kingdom, the quarterly rate of real GDP is expected to have moderated somewhat in the first quarter of 2008, having stood at 0.6% in the last quarter of 2007. Although retail sales in the three months to February increased by 1.0% on the previous three months, consumer confidence indicators were down and growth in predominantly non-food sales was weak. Furthermore, the Bank of England Agents' summary of business conditions in March again indicated falling investment and employment intentions. Moreover, growth in manufacturing producer prices remained at a high level in February, reflecting higher food and petrol prices as well as the depreciation of the pound sterling. On 10 April the Bank of England's Monetary Policy Committee decided to cut its main policy rate by 25 basis points to 5.00%.

Japan

In Japan there has been a slowdown in economic activity in recent months, following the revision of the Building Standard Law in June 2007 which resulted in a significant drop in housing and corporate construction starts in the second half of last year. Moreover, private consumption growth has remained limited, against the background of declining consumer confidence and increasing headline inflation.

Consumer price inflation has returned to positive territory in recent months as a result of the rise in the price of imported raw materials, while domestic inflationary pressures have remained subdued. In February 2008 the annual change in the CPI was 1.0%, up from 0.7% in January. This acceleration was driven mainly by energy and food product inflation. The annual change in the CPI excluding fresh food was 1.0%, up from 0.8% in January.

At its meeting on 7 March 2008 the Bank of Japan decided to leave its target for the uncollateralized overnight call rate unchanged at 0.50%.

Forecasts: World GDP Growth (Selected Trading Partners)

Country	*Latest*	*2008*	*2009*
Australia	3.9	3.3	3.2
Canada	2.9	1.7	2.2
Japan	2.0	1.4	1.6
United Kingdom	2.9	1.9	2.0
United States	2.5	1.5	2.2
Euro Area	2.2	1.5	2.2

Source: Economist

Forecasts: World Consumer Price Inflation (Selected Trading Partners)

Country	*2008*	*2009*
Australia	3.1	2.7
Canada	1.9	2.0
Japan	0.6	2.0
United Kingdom	2.4	2.0
United States	3.2	2.2
Euro Area	2.5	2.0

Source: Economist