BUSINESS NZ

PLANNING FORECAST

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BusinessNZ

Outlook for NZ economy continues to improve

Executive Summary

Confidence and commodities

Business confidence has improved strongly after taking a sharp but temporary drop as a result of the Christchurch earthquake in February this year.

The pleasing factor is that confidence is generally up across the board but particularly so in key export sectors. Confidence in the agricultural sector has improved largely as a consequence of continued high international commodity prices, plus Fonterra's favourable opening projected payout to dairy farmers for the upcoming 2011/12 season.

High commodity prices have not been restricted to dairy but apply across the board and include forestry. This bodes well for stronger regional growth as farmers will begin to reopen their wallets having to date been engaged largely in reducing massive debt burdens.

Domestic and household confidence is still relatively subdued although both qualitative and quantitative data are indicating moves to greater consumption, reflected in slight rises in retail sales and electronic transactions of late. Broadly supporting increased consumer confidence is a housing market finally showing some evidence of price stability. And a strongly improving outlook for the labour market will further encourage confidence for the future.

While domestic conditions are gradually improving, a number of international issues still give cause for concern. The continuing weakness of the US economy, high and unstable debt levels amongst many developed countries, concerns over rising inflationary pressures, and ongoing political instability in a number of countries all add up to a rather nervous world economy.

Global Growth & Trade

The Organisation for Economic Cooperation and Development's (OECD) latest Economic Outlook forecasts world Gross Domestic Product (GDP) to increase by 4.2% this year and 4.6% in 2012. But these figures are boosted by growth in developing countries outside the OECD. Growth in OECD member countries is forecast to be a little over 2.5% this year, increasing to 2.8% next year. The forecasts emphasise the risks to achieving this level of growth, including: possible further increases in oil and commodity prices - which, could feed into core inflation - a stronger than projected slow-down in China, the unsettled fiscal situation in the US and Japan, and renewed weaknesses in housing markets in many OECD countries. As well, financial vulnerabilities remain in the euro area in spite of efforts by a number of countries to bring in austerity measures.

HIGHLIGHTS

BusinessNZ's Economic Conditions Index (ECI) sits at 22 for the June 2011 quarter, up 10 from the previous quarter and up 19 on a year ago.

The continuing rise in world commodity prices has been very positive for NZ's terms of trade (a measure of the price of exports compared to imports). Terms of trade are now at levels not seen since the early 1970s.

While some international markets are still volatile - underpinned by concern about sovereign debt levels and rising inflation in a number of countries - the world growth outlook is forecast to remain strong, particularly amongst non-OECD countries.

NZ's key export trading partners, notably China and Australia, continue to perform well, despite some recent hiccups – China in respect to inflationary pressures, and Australia following the recent floods.

In NZ itself both businesses and consumers have to date been firmly focused on reducing debt burdens. However, with domestic conditions continuing to improve and consumer confidence starting to rise again, there are now some signs of change.

Consumer confidence is likely to rise further as the labour market continues to improve but risks remain that higher inflationary pressures will erode confidence.

Luckily, NZ does not face a number of these issues since they have mainly affected OECD countries. However, given NZ's position as a producer, small in world terms but nonetheless a major player in traded agricultural commodities, uncertainty, particularly amongst more traditional wealthy countries, is of ongoing concern.

On the positive side, NZ's major trading partners, notably Australia and China, continue to perform well, despite recent blips in output due to floods in Australia and the higher interest rate squeeze on inflationary pressures in China.

2011 Budget

The Government's Budget came and went, and while some useful trimming of unnecessary expenditure was signalled, including changes, some substantial, others cosmetic, to KiwiSaver, Working for Families, and student loans, the big elephant in the room – entitlement to NZ superannuation - was left alone.

While the business community will support the general direction of the Budget, leaving such a big issue as entitlement to NZ Superannuation without signalling even timeframes for reform was a lost opportunity. This issue will need to be addressed further down the track. However, on the positive side, the Government's books are forecast to return to surplus by 2015, one year earlier than previously forecast, while contributions to the NZ Superannuation Fund will resume in 2016/17, two years earlier than expected.

Slightly disconcerting is the fact that returning to surplus within this timeframe is highly dependent on achieving the reasonably solid growth forecasts out to 2015. If growth does not eventuate as predicted, then it will be apparent the forecasts were valueless. However, current and projected growth forecasts appear to be reasonably conservative, given an expectation of much higher growth on the back of high international commodity prices, the rebuild of Christchurch starting next year and the results and flow-on effects of one-offs such as the Rugby World Cup later this year.

The Budget's rather lukewarm approach to regulatory reform, with only casual support for the Regulatory Standards Bill and Spending Cap (People's Veto) Bill, is disappointing given that the quality of regulation needs to improve. Without this, departmental and one-off reviews of red-tape are unlikely to work, however many are carried out.

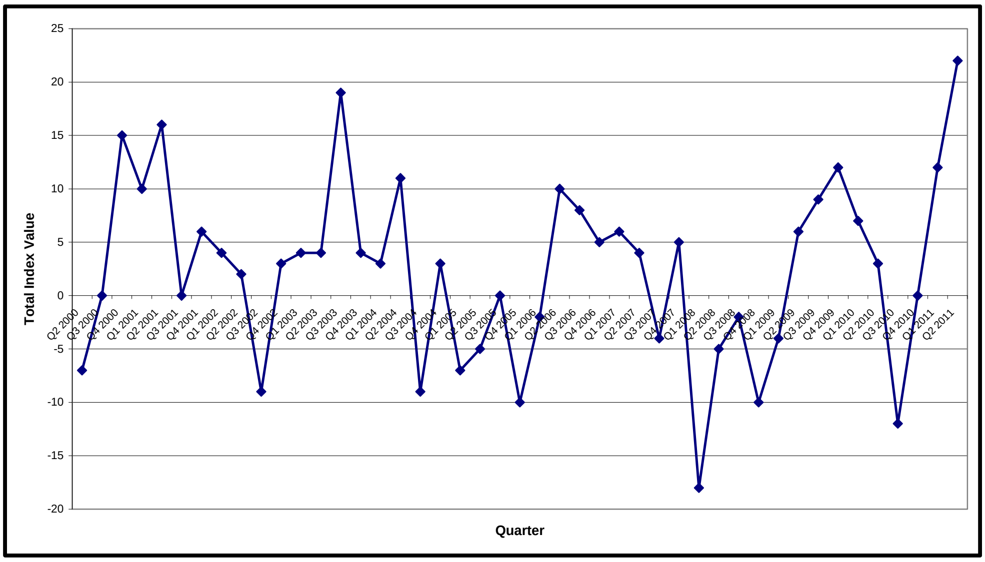
As BusinessNZ has advocated for some time, it is important for the Government to have a sound set of principles to guide the policy process when engaging in fiscal and regulatory decision-making. Without a Regulatory Standards Bill, the danger is the tendency to drift towards policy decisions on the hoof, with decisions made with no clear understanding of potential unintended consequences. For this reason, it is important for Government to commit to sending the Regulatory Standards Bill to the relevant Select Committee, calling for submissions, making any necessary changes, and passing the Bill into law as soon as is reasonably practicable.

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

BusinessNZ Economic Conditions Index (ECI)

The overall BusinessNZ Economic Conditions Index (a measure of the major economic indicators) sits at 22 for the June 2011 quarter, is up 10 from the previous quarter and up 19 on a year ago.[1]

Overall Economic Conditions Index (ECI)



Source: BusinessNZ

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

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

In terms of the ECI sub-groups:

Economic growth/performance indicators sit at 6 for the June 2011 quarter, up 2 on the last quarter and up 6 on a year ago. Relatively high international commodity prices by historical standards have resulted in the best terms of trade (a measure of the price of exports compared to imports) since the early 1970s.

Monetary policy/pricing indicators sit at 3 for the June 2011 quarter, down 3 on the last quarter but up 5 on a year ago. Rising inflationary pressures both from domestic and international sources will put added pressure on the Reserve Bank to raise interest rates.

[1] The ECI tracks 33 indicators on a quarterly basis. The overall index value for any particular quarter represents the net balance of the 33 indicators (generally the number increasing minus the number decreasing) thus providing an overall measure of performance. In general, increases in an indicator are seen as positive (e.g. growth in GDP or employment) and declines as negative. However, this is not always the case. For example, declines in unemployment are seen as positive and increases as negative.

<u>Business/consumer confidence indicators</u> sit at 8 for the June 2011 quarter, up 9 on the previous quarter and up 4 on a year ago. Business confidence has rebounded after taking a sharp dive in the March quarter on the back the February Christchurch earthquake. Consumer confidence is also edging up.

<u>Labour market indicators</u> sit at 5 for the June 2011 quarter, up 2 on the previous quarter and up 4 on a year ago. StatisticsNZ's Household Labour Force Survey (HLFS) showed very strong employment growth in the March 2011 quarter with reductions in unemployment. Severe negative projections of the effect of the Christchurch earthquake on jobs appear to have been overstated, given recent data on unemployment benefit registrations. However, it will be some time before a true reflection of the impact of the earthquake on job losses and displacement is thoroughly understood since there have been various government assistance packages aimed at retaining employment in that region.

Part 2: The New Zealand economy – where are we going?

1.1. Economic growth (GDP) – outlook good for next year and beyond

In light of events over the last year and particularly more recently, notably the Christchurch earthquake in February, it is not too surprising that banks and other forecasting agencies have severely cut back their forecasts for the current year. However, looking forward to next year and beyond, growth well over 3% is expected, as outlined in the forecasts below. Indeed, the Treasury, in its forecasts announced at the time of the recent 2011 Budget has growth forecast at 4% for the year to March 2013, 3.0% for the year to March 2014 and 2.7% for the year to March 2015.

Forecasts: Real GDP % Growth

	Years Ending		
	Jun 11	Jun 12	Jun 13
Highest	0.8	3.3	4.7
Average	0.7	3.2	3.9
Lowest	0.5	2.8	3.1

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

Some have questioned the Treasury growth rates as being too optimistic given NZ's abysmal growth rate over the last 2-3 years. However, it should be remembered that quite apart from the global financial crisis (GFC), which NZ came through relatively unscathed compared to many other countries, the NZ economy has suffered a number one-off hits over the last year or so, largely beyond the control of either Government or the private sector.

These one-off hits include:

- Legacy issues associated with the pork barrel politics of the later years of the last administration, particularly the move towards interest free students loans (representing a return to government of about 50 cents for every dollar spent!).
- Working for Families (extension of middle class welfare)
- Subsidised KiwiSaver (with over $1 million annually coming from Government (taxpayers) - in effect, churning
- Ongoing impact of the GFC
- Finance company collapses and impact of Government guarantees
- Pike River mining disaster
- Ongoing saga of leaky buildings
- Christchurch earthquakes
- Possible AMI bailout….and the list goes on.

While one can never be certain that there is not another substantial event around the corner, it is fair to say that the current Government has had to deal with a number of significant and costly issues which are certainly not of its on making. Not for a long time has the NZ economy been affected by such pressures, perhaps not since 1984 when the incoming Government faced monumental problems leading to the significant reforms of the mid-1980s.

Despite the above issues, many of which the Government is beginning to address, there is every reason to expect that the growth projections outlined above can be achieved.

First, international commodity prices continue to go from strength to strength, reflected both in Fonterra's international online auction and the company's recent announcement of a favourable initial projected payout for the upcoming 2011/12 year. With relatively favourable growing conditions, dairy production has been up on last year and favourable export prices (despite some concerns about the $NZ/US cross rate) have resulted in the best terms of trade since the early 1970s.

NZ's trade balance hit a record monthly surplus in April 2011 with merchandise exports climbing 17% to $4.7 billion on the back of sales of dairy, meat, wool and forestry products. By contrast, the value of imports rose 7.2%. Dairy products accounted for over a quarter of all exports for the month with exports to China and Australia the key.

The ANZ Commodity Price Index now stands at 343.5, up 0.3% from the previous month and an impressive 24.2% from a year ago. Even when converted into NZ dollars, with the impact of exchange rates taken into consideration, returns have still improved considerably. The index is up a healthy 11.7% on a year ago and now stands at 236.8. Perhaps of greater importance is the fact that over the last year commodity prices have generally increased across the board and have not been restricted to one particular sub-sector.

ANZ Commodity Price Index

	World Price Index	Monthly % Change	Annual % Change	NZ$ Index	Monthly % Change	Annual % Change
May 2007	214.5	n.a	21.2	165.6	n.a	5.4
May 2008	254.6	n.a	18.7	187.4	n.a	13.2
May 2009	182.2	n.a	-28.4	165.8	n.a	-11.5
May 2010	276.6	n.a	51.8	212.0	n.a	27.9
May 2011	343.5	0.3	24.2	236.8	-0.8	11.7

Source: The ANZ Commodity Price Index – May 2011

Second, world growth, although mixed, is expected to continue to improve over the next few years, good news for largely export-dependent countries such as NZ, as mentioned earlier. NZ's major trading partners (notably Australia and China) are continuing to show solid growth, recent blips notwithstanding.

Trade with China is now booming and total trade between New Zealand and China has increased by more than a third, from $8.5 billion to $11.1 billion, since the Free Trade Agreement came into force a couple of years ago. New Zealand's exports to China, now worth $4.5 billion, have almost doubled in the past two years, with growth in all major export sectors.

Third, the resources and rebuild of Christchurch will add substantially to growth next year although it is important to understand that such an horrific loss of life and destruction of capital will effectively simply divert resources from other activities.

While there are various estimates of the costs of the earthquake, ranging up to $30 billion in some cases, the Government has stated in the recent Budget that the rebuilding of Christchurch is a major goal of the Budget 2011 and has estimated that the damage caused by the two major earthquakes will amount to around $15 billion (about 8% of GDP). To put this in context, the March earthquake off the north-east coast of Japan is estimated to have caused damage equivalent to around 3% to 5% of Japan's GDP.

While the Government has clearly stated that the fiscal cost faced by central government as a result of the earthquakes remains uncertain, Treasury has made initial estimates that the direct impact on the Crown is likely to be just under $9 billion. While some of this reflects Government's Earthquake Commission (EQC) obligations and Accident Compensation Corporation (ACC) costs, around two-thirds reflects the Government contribution or share of funding in respect to local government infrastructure, roads, insurance excesses on schools and hospitals, temporary housing and other policy responses directly related to the earthquake. This is a huge fiscal stimulus in anyone's language and will certainly boost activity strongly next year as the rebuild gets underway and gains momentum.

Fourth the Rugby World Cup (September/October 2011) is potentially huge for NZ, not only in respect to retail, hospitality and tourism, but also in relation to longer-term contacts and business links extending well beyond the actual World Cup event itself. Given the gestation period, businesses and households have been provided with a fair amount of time in which to get their house in order so as to take advantage of this one-off opportunity.

As stated above, growth rates cannot be guaranteed. However, given the above positive factors impacting on the NZ economy, the projections of 3-4% growth for 2012 and 2013 appear highly likely. High debt levels and associated debt servicing costs and exchange rate pressures are still risks to the NZ economy but at this stage appear to be the only foreseeable head winds.

1.2 Monetary Conditions – pressure building

Interest rates – slow rise still likely

The 90 day bill rate is forecast to increase slowly and reach 5 percent by June 2013 as evidenced in the forecasts below.

While the Official Cash Rate (OCR) was reduced 50 basis points to 2.5 percent as a direct result of the Christchurch earthquake, interest rates rises are increasingly likely for a number of reasons.

First, and perhaps most importantly, current interest rates are at what could be described as an artificially low level, when compared to long-run averages over the last decade or so. Therefore a move back towards more neutral levels can be expected as the economy gathers momentum.

Second, while broadly in the right direction (e.g. an increase in GST and reductions in personal income tax rates), a number of Government policy decisions last year resulted in one-off adjustments to the Consumers Price Index (CPI) that nevertheless, will take a couple of quarters to work their way out of the system.

While the Reserve Bank has the ability to look through the results of one-offs (whether domestically generated or internationally generated (e.g. oil price shocks), the concern is that individuals and businesses may not be in a position to do so when negotiating labour supply contracts or renegotiating rents and other such contracts.

Third, improving labour market conditions are likely to put upward pressure on wage rates as employers seek to retain staff. Employees too will be looking for wage rises, not only as the market improves but also because a general weakness in the economy has meant that wages have been tightly contained over the last couple of years. Particular pockets of inflationary pressure are likely to arise as a result of the Christchurch rebuild, given the enormity of the task. Competition for skilled tradespeople from Australia is also likely to be an ongoing issue.

Fourth, international commodity prices remain at evaluated levels and are expected to remain at evaluated levels (for a range of reasons including strong demand and international uncertainty in respect to oil supplies), obviously putting increased pressures on domestic prices such as food and oil.

Fifth the Christchurch rebuild will put upward pressures on prices as a fine line is trodden between getting things back on track as fast as possible and ensuring that prices remain at reasonable levels.

Sixth, new Reserve Bank capital adequacy ratios for farm lending could well put some upward pressure on interest rates, at least on the margins.

Finally, a credit rating downgrade of Australia/New Zealand bank credit ratings may well see some upward pressure on interest rates given the country's reliance on foreign capital. However, the Government has clearly stated that it has had no problem accessing capital at reasonably favourable terms over recent months.

Despite some moves to repay debt by businesses and households, NZ's household liabilities are over 150 percent of disposable income – 50 percent higher than 10 years ago, making the NZ economy vulnerable to any significant change in international investor sentiment.

Forecasts: Interest Rates (90 day bills)

	As at end of		
	Jun 11	Jun 12	Jun 13
Highest	3.3	4.7	5.3
Average	3.2	4.3	5.0
Lowest	3.2	4.0	4.7

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

The New Zealand dollar – still bobbling about

Forecasts below show that the $NZ, on a trade-weighted-Index (TWI) basis, is expected to stay relatively constant out to June 2013.

Focus by some commentators has been on the $NZ/US cross rate which doesn't necessarily provide a good overall picture of the economy given that the US economy is still in deep trouble and many investors are moving to other currencies, including NZ, where future prospects are considerably better. For example, against the Australian dollar, the NZ dollar has deprecated by around 7 percent over the past year and is close to its lowest point in 20 years while it has hardly moved against the currencies of many of our major trading partners e.g. euro, pound, and yen.

The table below provides a snapshot of the $NZ against significant world currencies since 2005. Despite the blip in 2009 largely as a result of the Global Financial Crisis (GFC), on a TWI basis, the $NZ has been relatively stable at around 70 cents.

Exchange Rates

Average for period ending	**USA**	**UK**	**Aust.**	**Japan**	**Euro**	**TWI**
May 2005	0.7191	0.3871	0.9307	76.64	0.5661	70.9
May 2006	0.6314	0.3384	0.8274	70.65	0.4950	62.7
May 2007	0.7325	0.3692	0.8885	88.43	0.5419	71.3
May 2008	0.7769	0.3951	0.8188	81.00	0.4992	69.3
May 2009	0.5990	0.3891	0.7855	57.92	0.4394	58.0
May 2010	0.6992	0.4761	0.8019	64.36	0.5557	67.0
May 2011	0.7959	0.4868	0.7447	64.60	0.5550	68.7

Source: Reserve Bank of NZ

While the future direction of the $NZ is uncertain, there are potential upward pressures arising from a number of factors.

Relatively strong forecast growth and continuing high commodity prices will add to inflationary pressures bringing an inevitable response from the Reserve Bank in the form of a rise in interest rates.

A relatively weak world economy and particularly US prospects will encourage investors to move to commodity based currencies such as the $NZ.

Reinsurance inflows from overseas as a result of the Christchurch earthquake will put added pressure on the dollar, given the billions of dollars involved.

Finally, there has been some talk in the media of potentially large NZ investments from Chinese sources which could also put upward pressure on the dollar.

Downside pressure on the dollar will likely be restricted to issues around growth rates and whether or not current forecast growth rates of 3-4% can be delivered, taking some pressure off the Government in terms of borrowing requirements from overseas.

Forecasts: Exchange Rates

AUD (cents)			
	Jun 11	Jun 12	Jun 13
Highest	0.759	0.802	0.875
Average	0.746	0.773	0.804
Lowest	0.730	0.720	0.750

USD (cents)			
	Jun 11	Jun 12	Jun 13
Highest	0.820	0.770	0.790
Average	0.781	0.750	0.743
Lowest	0.740	0.720	0.690

TWI			
	Jun 11	Jun 12	Jun 13
Highest	70.3	69.1	71.1
Average	67.9	68.0	68.1
Lowest	65.6	65.7	64.3

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

Inflation - upward pressure building

Forecasts outlined below show that inflation is likely to be just within the Reserve Bank's target of 1-3% for the year to June 2012 and 2013 after earlier breaking the band largely as a result of one-offs, including the hike in GST on 1 October 2010.

Despite a general consensus that inflation will remain under control, there are a number of worrying signs emerging, not least business and consumer expectations of rising inflation.

While some surveys predicting inflation of between 5-10% can be considered to be in fantasy land, consistent messages are pointing to building pressures, both as result of domestic and international pressures. The danger is that expectations will become a self-fulfilling prophecy.

Internationally, pressure is coming from high commodity prices, while NZ’s strong trade relationship with China, though very positive, will result in higher imported inflation, since inflationary pressures in China are still high with annual inflation around 10% per annum. Because NZ imports so much from China, it naturally, at the same time, imports China’s inflation.

Other pressures are likely to arise from a strong rebound in labour market conditions with potential skill shortages likely to dominant in the trades’ area in particular.

Despite building inflationary pressures, the Reserve Bank in its latest review of the OCR (9 June 2011) was relatively neutral in respect to underlying inflationary pressures: *“Headline inflation is currently being boosted by recent increases in indirect taxes, food and petrol prices, and surveyed expectations of future inflation have edged up. Despite this, indicators of capacity usage and core inflation suggest underlying inflation remains constrained.”*

The saving grace to some extent has been the relatively high dollar, particularly against the US. This, to a certain extent, has sheltered NZ businesses and households from the worst excesses of international increases in prices, particularly for food and oil.

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Jun 11	Jun 12	Jun 13
Highest	5.4	3.0	3.3
Average	5.3	2.8	3.0
Lowest	5.1	2.6	2.8

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

1.3 Business and consumer confidence – consolidating at higher levels

Business confidence – continues to rise

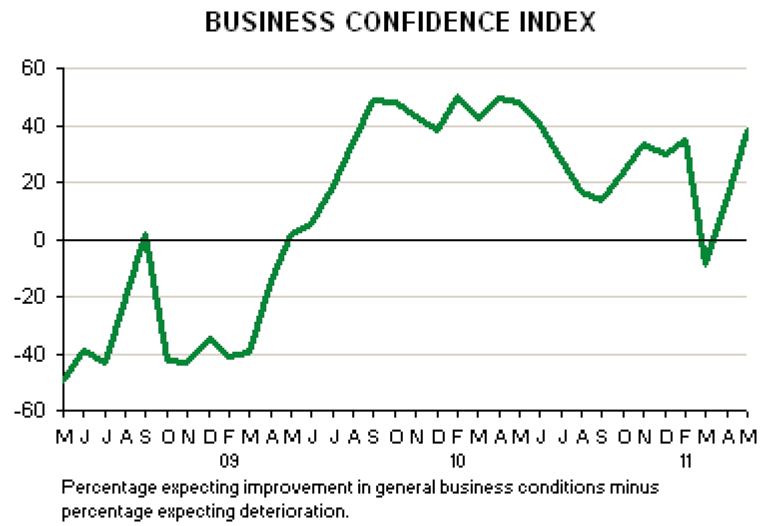
The National Bank’s Business Outlook (May 2011) indicates that confidence continues to improve relatively sharply after taking a brief pounding in March in the aftermath of the Christchurch earthquake.

A net 38% of businesses expect better times for the economy over the coming year, up 24 points on April. As is crucial with such surveys, the more important results are businesses’ own activity expectations and it is pleasing that these have also shown a significant lift. A net 40% of businesses expect better times ahead for their own business, up 10 points on the previous month.

Drilling slightly below the headline results shows the sub-indicators to be improving relatively strongly with increasing confidence to invest (up from 6 to 15), employment intentions (up from 6 to 13), and importantly, profit expectations (up from 8 to 23). All are now above their long-term average boding well for future employment growth.

While the pessimists might well point to similar results in mid-2010 which didn’t subsequently deliver, it is unfair to make such comparisons given the number of knocks, mostly unavoidable, to the NZ economy - the two major Canterbury earthquakes taking centre stage.

National Bank Business Confidence Index



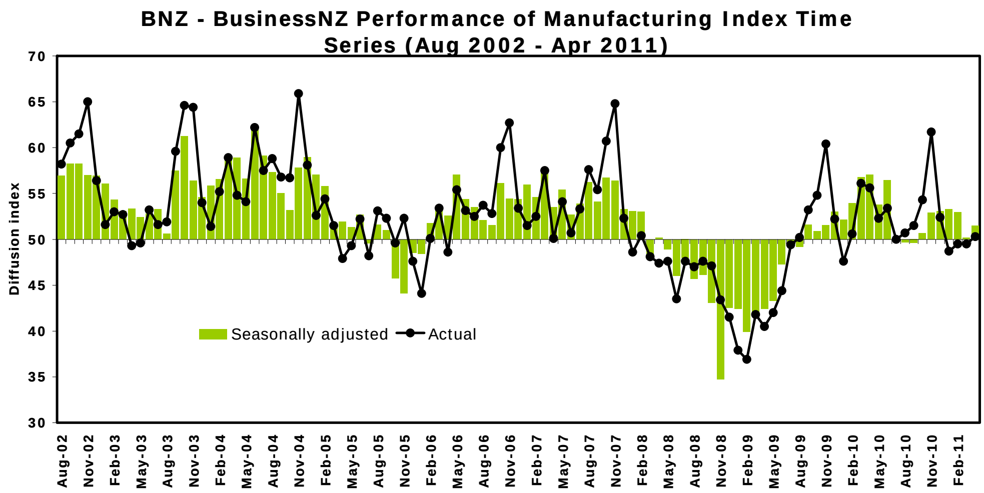
Source: National Bank of NZ

Other surveys of business confidence also reflect improving conditions.

The BNZ Confidence Survey (6 June 2010) shows a net 57% of respondents expecting that the economy will be better in a year's time, significantly up on the May result (42%). The latest result is the highest level since the survey began 5½ years ago. Not surprisingly, expectations are for higher growth as a result of the Christchurch rebuild, the impact of the Rugby World Cup and strong positive sentiment from the agricultural sector on the back of continuing higher commodity prices.

Of some concern is the fact that pricing and inflationary expectations continue to creep up. Inflationary expectations have increased to 3.3% (previously 3%) for the next year while pricing intentions have also risen.

An improvement in business confidence is being reflected in a more consistent improvement in the manufacturing sector. The latest BNZ-BusinessNZ Performance of Manufacturing Index (PMI) shows manufacturing activity continuing to pick up.

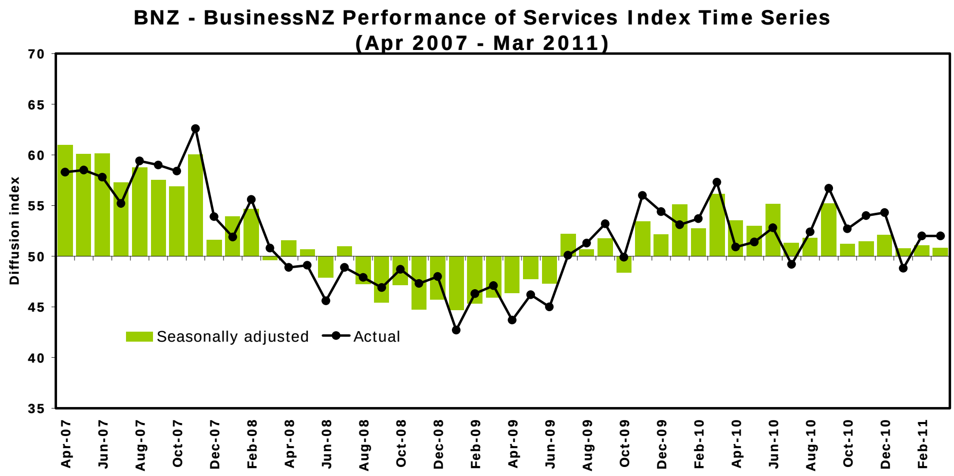


Source: BusinessNZ

The PMI (seasonally-adjusted) for the month of April 2011 was 51.5, up slightly from 50.2 in March 2011. A reading above 50 indicates that activity is expanding; below 50 indicates that it is contracting. Four out of the five indices (which combined make up the overall PMI) - *production* (52.8), *new orders* (52.9), *finished stocks* (54.8) and *deliveries* (51.6) - were all in expansion for the third consecutive month. The only negative was *employment* (49.9) which was marginally in contraction mode.

The continuing expansion of new orders for 7 of the last 8 months is an encouraging indicator that expansion will continue, even if it is slow and steady.

The seasonally adjusted BNZ-BusinessNZ Performance of Services Index (PSI) for April 2011 (52.6) was up 1.5 points from March 2011. All five indices remained in positive territory, with employment (53.0) and new orders (53.8) showing steady growth.



Source: BusinessNZ

While the service sector continues to expand overall, the devil is in the detail with some sectors clearly in strong expansion phase while others remain subdued.

In April, the various service sectors were again a mix of expansion and decline. *Property and business services* (55.1) and *health & community services* (51.5) showed positive growth, while *retail trade* (46.9) slipped slightly from March and *wholesale trade* (47.4) went into contraction for the first time since January 2011.

Consumer confidence – slowly rising

Unlike the strong rebound in business confidence, consumer confidence continues to improve only modestly.

The ANZ-Roy Morgan survey shows that confidence bottomed out in March after trending down for much of 2010 and into 2011. Consumer confidence increased by two points to reach 103 in May 2011. However, such movement is considered to be well within the normal volatility associated with surveys of this kind so not too much should be read into the slight improvement to date. Nevertheless, other surveys and recent quantitative data (e.g. electronic sales) show that consumers are slowly but surely starting to reopen their wallets in light of an improving economic outlook, including relatively strong forecast employment growth and lower projections for unemployment.

A One News Colmar Brunton poll in May (after the Budget) showed 48% of surveyed respondents as optimistic for the economic outlook (up 10 on the previous month) while 33% remained pessimistic (down 12% on a month earlier).

While it might have been assumed that the personal income tax cuts from 1 October would have boosted confidence somewhat and assisted in improving disposable incomes, a range of factors may be continuing to act to dampen consumer confidence.

High levels of household debt remain a concern despite moves over recent times to cap the expansion of debt. Higher projected interest rates will impact on disposable income while some changes announced in the Budget, such as tightening up the subsidies for KiwiSaver (although justified), may be affecting household perceptions.

Rising prices for staple foods and petrol are also impacting on consumer confidence, although to some extent the worst of price increases have been offset by the relative strength of the $NZ compared to the US in particular. This has taken some of the sting out of increases in international commodity prices.

Insurance premiums will rise substantially in light of the recent earthquake in Christchurch as reinsurance markets re-price risk across the board.

On the other hand, there are a number of positive signs coming out of recent labour market data (even though these need to be taken with a healthy grain of salt).

The housing market has also stabilised with the latest BNZ-REINZ Market Survey of over 10,000 licensed real estate agents pointing to a rapidly strengthening upturn in Auckland's residential real estate market, although other areas remain relatively subdued. These positive results are important for consumer confidence given the amount of equity and debt locked up in housing.

1.4 Labour market – significant improvements noted

Employment – rising

Quarterly results from StatisticsNZ's HLFS have fluctuated wildly over the past year or so, but the general direction over recent quarters has been for relatively strong employment growth.

During the March 2011 quarter, the unemployment rate fell to 6.6%. This was largely the result of very strong employment growth (an increase of 30,000 jobs in the March quarter). However, while part-time employment rose by 4.0% in the March 2011 quarter, full-time employment rose only 0.5%. Increases in part-time employment rather than full-time employment indicate that while the labour market is improving, it is still relatively tentative. As the economy improves, it can be expected that growth in employment will be driven increasingly by full-time rather than part-time employment.

Expectations for further employment growth are evident in a number of surveys of businesses while forecasting agencies, including the Treasury in its latest Budget forecasts, are predicting steady employment growth and subsequent further drops in the level of unemployment. Forecasts below show unemployment projected to drop below 6% by June 2012 and drop further to around 5.3% by 2013.

Job ads continue to rise, a good leading indicator of further employment growth, although they are still well down on the boom times of the mid-2000s.

While there were expectations that the Christchurch earthquake in February would have caused widespread increases in unemployment and dislocation for many employees, this appears not to have been to the extent previously envisaged. There is likely a range of reasons for this, including the Government's initial post-earthquake employment packages, which encouraged a close connection between employees and their business.

The increase in the number of registered unemployed in the Christchurch region has been relatively modest, while overall registered unemployment has dropped slightly. However, such figures need to be taken with a grain of salt given the incentives or otherwise to register as unemployed.

Household Labour Force Survey: March 2011 quarter

Seasonally adjusted	**March 2011 quarter**	**Quarterly change**	**Annual change**
Unemployment rate	6.6%	-0.1	+0.5
Unemployed	155,000	-1.4%	+9.4%
Employed	2,214,000	+1.4%	+1.8%
Not in the labour force	1,081,000	-2.2%	-0.7%
Labour force participation rate	68.7%	+0.8	+0.7

Source: Statistics NZ

Notwithstanding all the positive news and the outlook for further significant employment growth, the huge rate of unemployment amongst the young and unskilled, and amongst Maori and Pacific groupings, spells both economic and social disaster further down the track unless rapidly addressed. While there is no one silver bullet, gaining initial attachment to the labour market is an important discipline helping to improve an individual's productivity and hence that individual's earning potential over time. Matters such the reintroduction of the youth minimum wage are just one part of a strategy for addressing what can only be described as an unacceptable outcome to date.

Forecasts: Unemployment % (HLFS)

	Quarter		
	Jun 11	Jun 12	Jun 13
Highest	6.9	6.2	6.0
Average	6.8	5.9	5.3
Lowest	6.7	5.3	4.2

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

Labour costs – upward pressure to come

Labour market pressures have been relatively subdued so far but increasing participation rates (close to record highs) and anecdotal reports of salary rises as, with improving conditions, employers seek to retain skilled staff, will likely put upward pressure on wage rates. Latest official figures available show that salary and wage rates (including overtime), as recorded by the Labour Cost Index (LCI), increased by 1.9% in the year to the March 2011 quarter.

Forecasts below indicate that labour costs are expected to increase modestly to around 2.5 percent for the year ending June 2012 and increase slightly faster in 2013. This is very much in line with the long-run average for the LCI.

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

	Years ending		
	Jun 11	Jun 12	Jun 13
Highest	2.1	3.3	3.6
Average	2.0	2.5	2.6
Lowest	1.8	2.0	2.0

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

However, given significantly improved prospects for employment growth, the forecasts above look a little on the soft side. This will be particularly if employees seek generalised wage increases in line with headline CPI inflation rather than, more accurately, in line with underlying inflationary pressures.

Relatively subdued net migration inflows of late (5,500 for the year ending April 2011) mean that the traditional pool of labour available to boost employment numbers is simply not there, possibly leading to upward pressure on wages. Similar pressure could come from a shortage of skilled employees, tradespeople in particular, as the Christchurch rebuild gets under way next year; competition from Australia, with substantially deeper pockets, could add further pressures over 2012 and 2013.