BUSINESS NZ

PLANNING FORECAST

MARCH 2009

BusinessNZ

Worst of recession yet to hit NZ

Executive summary

Economy

A recent survey by Research New Zealand suggests that many New Zealanders think the worst of the current recession may be over with 49 percent of respondents saying their financial position is worse or a lot worse than a year ago. Last year, that figure peaked at 56 percent saying they felt worse off. A third of those surveyed said that their financial situation had not changed from last year.

While it is important to stay positive, even in these turbulent and unsettled times, it is fair to say that the worst of the global recession has yet to hit New Zealand. In this respect, New Zealand's relative isolation from global markets can result in unsound assumptions as to the real impact of the global recession.

Arguably New Zealand is only beginning to feel the effects of the crisis now the global demand for goods and services has slumped. This slump in global demand is beginning to be felt by businesses in terms of their own activity outlook and is starting to impact on the household sector as a result of redundancies and rising unemployment.

Falling interest rates combined with a significantly lower exchange rate are acting as a partial buffer for exporters facing significant declines in export prices. Nevertheless, the significantly lower exchange rate has not been enough to stop falls in commodity prices when converted into NZ dollars with Fonterra again slashing their projected payout to dairy farmers for the 2008/09 year.

The one bright spot is that the inflation genie is firmly back in the bottle which will allow the Reserve Bank to lower interest rates even further should they so wish. However it is not inevitable that lowering the OCR will automatically result in one-for-one cuts to rates facing households and businesses. This is because of the extent to which banks borrow on wholesale markets which are only just starting to thaw on the back of significant overseas government guarantees and bailouts of the banking sector around the world.

Reduced interest rates, overall declines in fuel costs, continued tax cuts and a much more competitive NZ dollar have not been enough to arrest the slide in both business and consumer confidence. What is particularly concerning is businesses' assessment of their own activity levels going forward which is bleak. Given the very strong correlation between some business opinion surveys and Gross Domestic Product, recent results would suggest several more quarters of negative growth are likely before a weak recovery early in 2010.

Despite significant negative sentiment in New Zealand, there are a number of positives that should not be lost sight of. These include:

- Government debt is still low by international standards.

HIGHLIGHTS

Growth is expected to remain negative for several more quarters as world demand for goods and services continues to slump.

Reduced interest rates, overall declines in fuel costs, continued tax cuts and a much more competitive NZ dollar have not been enough to arrest the slide in both business and consumer confidence.

Falling interest rates and a more competitive NZ dollar are acting as a partial buffer to exporters facing declining returns from a continued drop in international commodity prices.

Inflationary pressures continue to ease on the back of reduced international oil prices and wage restraint on the back of a rapid deterioration in labour market conditions.

Despite significant sentiment in New Zealand, there are a number of positives that should not be lost sight of.

- Unemployment is still low.
- There is still room for significant interest rate cuts if necessary.
- Lower interest rates will help many households to service and progressively rein in debt.
- NZ does not have a surplus of housing stocks nor have banks, in general, supplied finance to those unable to service housing debt.
- NZ's banking system remains stable, even if credit is somewhat harder to come by.
- NZ has not had any shock collapses of banks or large companies.
- Although commodity prices are continuing to drop, NZ sells the kind of things that the world wants namely food and fibre.
- The Government's fiscal stimulus package(s) can be used for constructive infrastructure investment rather than being poured down bottomless pits as has occurred in a number of overseas bailout packages.
- Government reform measures have generally been positive so far, and specifically targeted towards reducing blockages in the economy and improving overall productivity.

Part 1: The New Zealand Economy

1.1. Economic growth (GDP) – still going backwards

Most recent outcome: +1.7 per cent for the year to September 2008

Gross Domestic Product 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 percent, indicating a relatively strongly performing economy with higher growth than many other developed countries. However, in line with many other countries, New Zealand is currently in recession, and has been since the first quarter of 2008.

Economic activity decreased 0.4 percent in the September 2008 quarter, the third consecutive decrease in economic activity. Annual growth in GDP was 1.7 percent for the September 2008 year but is expected to be negative on an annual basis for both the March years 2009 and 2010 as can be seen from the bank forecasts below. All the banks surveyed expect negative growth for both 2009 and 2010.

While earlier forecasts considered that the recession would be limited to the first three quarters of 2008, more recent data have put paid to that. In particular, the New Zealand Institute of Economic Research's latest Quarterly Survey of Business Opinion (QSBO) shows that firms' own activity expectations are by far the lowest in the history of the survey, with investment and hiring intentions plunging. Given the very strong correlation between the results of the QSBO and Gross Domestic Product (GDP) one can realistically expect at least two to three more quarters of negative growth before tentative growth returns towards the end of this year.

The NZ Treasury have also slashed their growth forecasts a number of times since the Budget in 2008. Even so, a number of commentators consider Treasury's most recent forecasts are still too optimistic and this has been backed up by the Minister of Finance who recently stated projections are now more likely to follow Treasury's more pessimistic downside scenario rather than the average main forecast.

Forecasts: Real GDP % Growth

	Years Ending		
	Mar 09	Mar 10	Mar 11
Highest	-0.5	-0.2	3.6
Average	-0.7	-0.8	2.8
Lowest	-0.8	-1.5	1.6

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

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

Interest rates – down, down, down

Who would have thought at the start of last year that the Reserve Bank would have reduced the OCR from 8.25 percent mid-2008 to 3.5 percent by 29 January 2009? Such has been decline in both global and domestic demand and associated commodity prices that Reserve Banks around the world have entered unchartered territory in the degree of movement in interest rates.

A 150 basis point cut to the OCR in December 2008 has been followed by another 150 basis points cut, bringing the OCR down to 3.5 percent. A number of forecasters consider further cuts are not out of the question given the negative outlook for the world economy.

Reserve Bank Governor Alan Bollard commented in the RB press release confirming the most recent drop in the OCR that *"the news coming from our trading partners is very negative. The global economy is now in recession and the outlook for international growth has been marked down considerably since our December Monetary Policy Statement."*

With the inflation genie now firmly back in the bottle, the ability of the Reserve Bank to move even further on lowering the OCR is available should they so wish. This is a luxury that many other countries do not have as they have already expended that option. However it is not inevitable that lowering the OCR will automatically result in one-for-one cuts to rates facing households and businesses. This is because of the extent to which banks borrow on wholesale markets which are only just starting to thaw on the back of significant overseas government guarantees and bailouts of the banking sector around the world.

Official Interest rates

Central Bank	Current rate (%)	Previous rate (%)
Reserve Bank of Australia	3.25%	4.25%
US Federal Reserve	0.25%	1.00%
Bank of England	1.00%	1.50%
European Central Bank	2.00%	2.50%
Reserve Bank of NZ	3.50%	5.00%

The New Zealand Dollar – close to bottoming out?

In line with significant interest rate cuts, the NZ dollar has also fallen rapidly with further falls possible. This underlines the importance of having a floating exchange rate as an automatic stabiliser given the worsening economic outlook. Nevertheless, despite a significant drop in the $NZ relative to most of our major trading partners, the drop has not been enough to offset the free-fall in international commodity prices when converted into NZ dollars.

A quarterly Nielsen survey on foreign exchange hedging conducted in December 2008 on behalf of Asia-Pacific Risk Management and the New Zealand Export Credit office found that exporters are generally hedging for a dramatically longer period on average, with a weighted average of 11.4 months hedging in December 2008 compared to 5.7 months in the June quarter. Obviously exporters are prudently taking the opportunity to lift hedging percentages whilst the currency is moving to cyclical lows.

Net migration flows – still declining but prospects improving

Net migration (which is a good leading indicator of general economic activity for the future) has continued to decline and is substantially down on the 11,400 average inflows recorded for the December years from 1990-2008. Net migration was 3,800 in the December 2008 year, down from 5,500 in the December 2007 year. The latest figure is the lowest for any 12-month period since the October 2001 year (1,700).

A net inflow of 40,900 non-NZ citizens and a net outflow of 37,000 New Zealand citizens were recorded in the year ended December 2008. The majority of the net outflow of NZ citizens was to Australia (35,300).

The net outflow to Australia was over 35,000 in the December 2008 year, up from 28,000 in the December 2007 year and higher than previous peaks in the January 1989 year (33,700) and the December 1979 year (33,400). To put this outflow to Australia in perspective, it is equivalent to the Westpac Stadium filled to capacity.

While it is too early to state with any great degree of confidence that the tide is turning, it is likely that net migration may have bottomed out with expectations of rising net inflows over coming months, for a number of reasons. The most significant reason is that New Zealand is perhaps better positioned than many countries to weather the current global crisis and with many countries in deep recession there may be added incentives for expat New Zealanders to return home as well as a desire for others to come here in light of our relatively cheap housing, low interest loans and a low exchange rate which may be temping for some foreigners considering relocating.

Commodity prices – continuing the slippery slide

The ANZ Commodity Price Index stood at 155.5 in January 2009 (down 4.3 percent from the previous month) and down 29.2 percent from its peak in May 2008. The Index is down 26.5 percent on the same time last year. Dairy products continue to take a hit with prices declining by 53.7 percent on the same time last year.

When converted into NZ dollars the ANZ NZ Dollar Commodity Price Index also went down in January 2009 (4.3 percent) to 146.4. On an annual basis commodity prices when converted into NZ dollars were only down 2.6 percent, reflecting the fact that a sliding $NZ against our major trading partners, particularly the US, has acted to offset the worst of the slump in international commodity prices. Nevertheless dairy products, when converted into NZ dollars were down a significant 35.2 percent compared to the same time last year.

Fonterra earlier scaled back its projected payout to farmers for the 2008/09 dairy season from $7 per kilogram to $6.60 per kilogram, and then followed this up with a further cut back to $6.00. This has more recently been followed up with a further cut to $5.10, announced on 28 January 2009. Given the significant decline in world dairy prices, it is possible that further downward revisions will be signaled before the final payout is determined, although this is unlikely given the scale of the latest revision. It is understood that already there is significant stockpiling of milk products on international markets which simply can't be moved at current prices. This will not be helped by the recent decision of the European Union (EU) to reintroduce export subsidies for their agricultural producers.

Notwithstanding this, it is important that the drop in commodity prices, including milk prices, is put in context. Fonterra's projected payout of $5.10 per kg, if delivered, will still be well above the long-term average of around $4.25 achieved over the last decade.

	World Price Index	Monthly % Change	Annual % Change	NZ$ Index	Monthly % Change	Annual % Change
Jan 2004	133.3	2.3	10.9	107.4	-0.7	-7.5
Jan 2005	153.1	0.7	14.9	117.1	1.8	9.0
Jan 2006	149.6	-0.2	-2.3	115.6	1.4	-1.3
Jan 2007	166.2	1.3	11.1	129.7	0.8	12.2
Jan 2008	211.7	-1.4	27.4	150.3	-1.8	15.9
Jan 2009	155.5	-4.3	-26.5	146.4	-4.3	-2.6

Source: ANZ Commodity Price Index NZ – 2 October 2008

Business confidence – down and out

Despite some pockets of optimism, indicators of both business and consumer confidence continue to be very negative. Particularly concerning from various business opinion surveys is firms' own activity expectations.

The NZIER's Quarterly Survey of Business Opinion (QSBO) released on 13 January shows that a net 43 percent of firms reported that they expect a drop in their own activity in the March 2009 quarter, the worst result since at least 1970. The speed of the decline, particularly in respect to employment and investment intentions, is alarming to say the least.

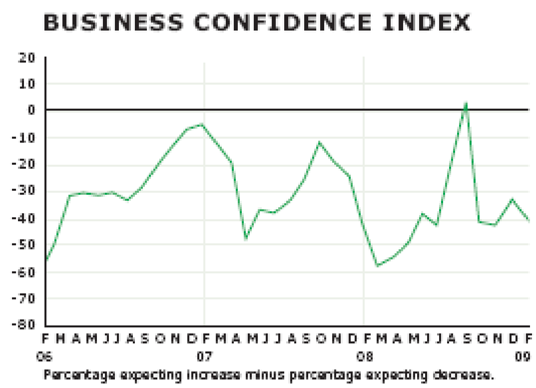
The historically strong correlation between business activity intentions and Gross Domestic Product would suggest there is every likelihood of continuing negative economic growth for much of 2009. On the bright side, as mentioned earlier, it does provide the Reserve Bank with scope to drop interest rates further.

On a seasonally adjusted basis, the net balance of firms reporting a decrease in their own activity in the December quarter 2008 was 44 percent, compared with a net 32 percent reporting a decline in the previous quarter. The 44 percent was the highest reported decrease since at least March 1970. In simple terms, the demand for goods and services has evaporated which means firms are struggling to move stock irrespective of the price discounting.

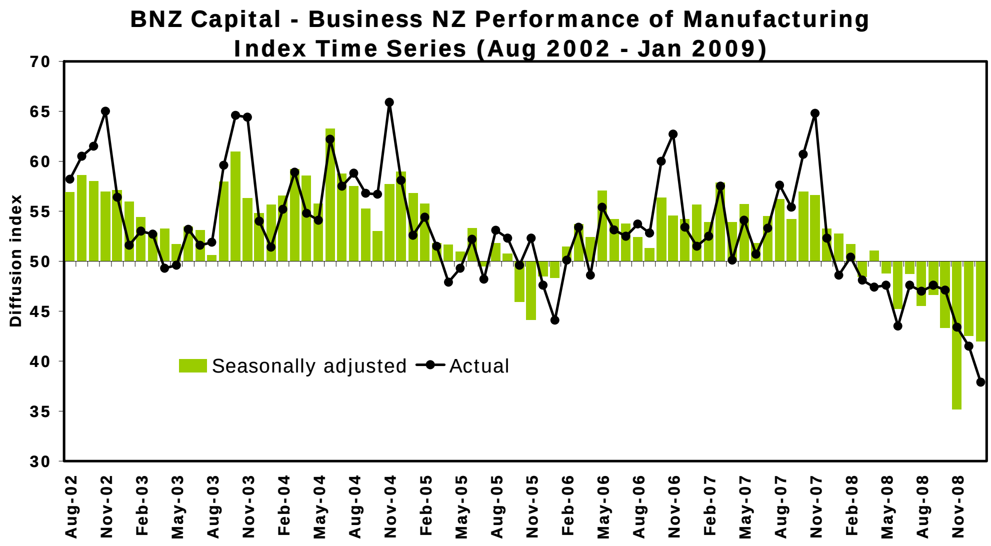
In the December 2008 quarter business capacity utilisation was 88.8 percent, the lowest since June 1999.

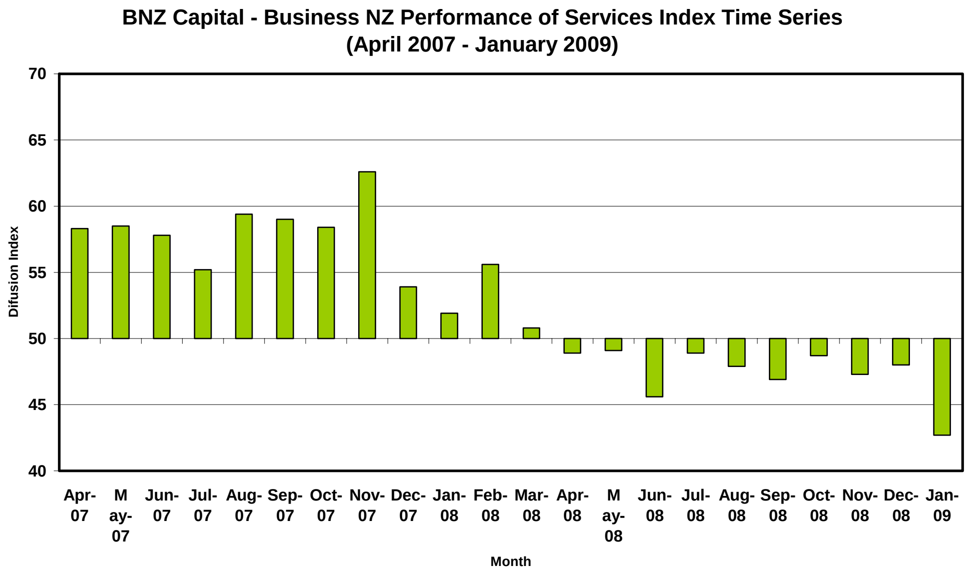
The National Bank's Business Outlook (February 2008) similarly shows a negative picture with respondents expecting the general economic situation to deteriorate over the coming year while firms' own activity expectations continue in the doldrums.

National Bank Business Confidence Index



This negativity is pronounced in other areas of business confidence such as the BNZ Capital – Business NZ Performance of Manufacturing (PMI) and Performance of Services (PSI) indexes. Both show activity continuing in decline with new orders falling away and finished stocks in positive territory. This would suggest that companies are having significant difficulties moving stock despite price discounts and this is obviously affecting profitability.





Consumer confidence – pessimism widespread

Consumers remain pessimistic despite a number of factors which should arguably have impacted positively on consumption. Significant reductions in interest rates, reduced inflationary pressures including a major drop off in petrol prices, and rolling personal tax cuts have not been enough to offset consumer pessimism generated by a relatively bleak employment outlook and associated rises in unemployment.

Perhaps the big factor which is impacting most on consumer confidence is the cracks appearing in the labour market, resulting in redundancies and rising unemployment. In many respects, employment is the glue which keeps consumer confidence in positive territory. Now that glue is becoming unstuck although unemployment is still low compared with recent historical standards.

The Westpac McDermott Miller Consumer Confidence Index fell to 101.3 in December 2008, down 3.5 points on the previous quarter. Despite the positive factors mentioned above, the prospect of a deep global recession in 2009 appears to have overwhelmed consumers, with a fear of significant job cuts and rising unemployment occupying the minds of many consumers.

This lack of consumer confidence has been reflected in a cut back in consumer spending with both electronic card spending and retail trade flat.

The housing market continues in the doldrums with limited sales and soft prices, although prices have not fallen to the extent that some commentators were suggesting. With interest rates falling rapidly, there will be opportunities for investors to enter the market and this will act as a buffer against significant further falls in house prices. Another buffer is the fact that building consents are still trending down, meaning less housing stock available for purchase at a time of likely rising net migration, as individuals and households return to NZ given the depressing outlook for many developed countries. Perhaps of more fundamental importance to housing prices is that unlike many other countries, New Zealand does not have a surplus of housing stock, nor have banks in general supplied finance to those unable to service housing debt. This means that forced mortgagee sales are still not having any major effect on the market yet.

Putting it all together – gloomy overall

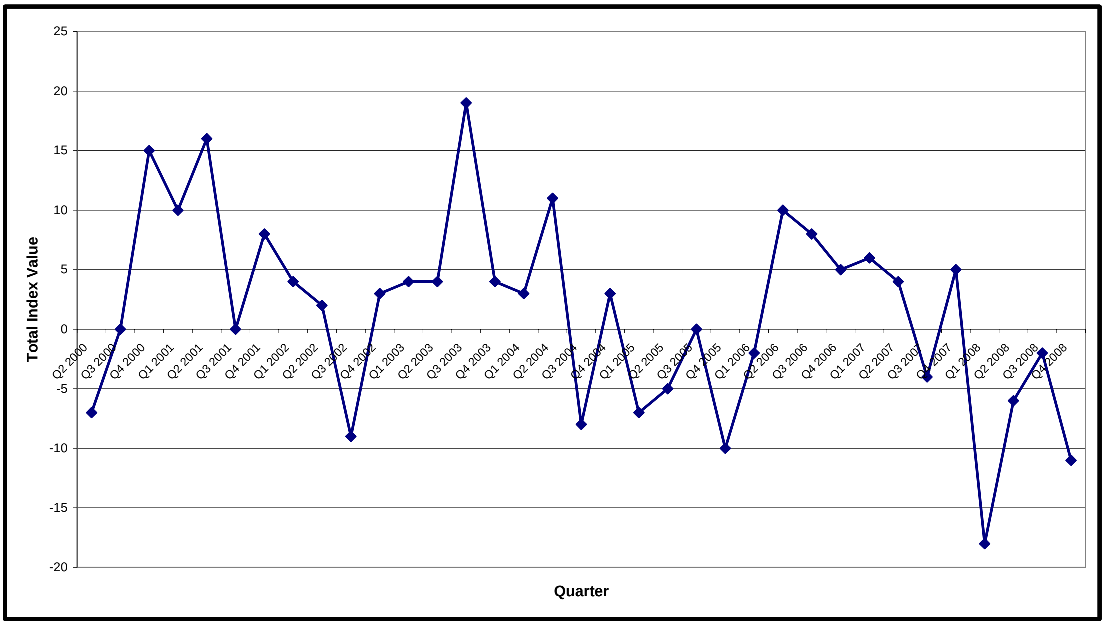
Business NZ Economic Conditions Index (ECI)

The overall Business Conditions Index (a measure of the major economic indicators) sat at -11 for the December 2008 quarter, down 9 on the September quarter and down 16 on a year ago.

Data is broken into four key sub-groups:

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

The overall ECI is currently sitting at its second lowest level since the index began in 2000.



Inflation – the genie is firmly back in the bottle

Most recent outcome: +3.4 percent, year-ended December 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 fell 0.5 percent after rises for 1.5 and 1.7 percent for the previous two quarters respectively.

Capacity utilisation is falling away, along with a slump in world commodity prices which is taking the heat out of inflation. Reductions in transport and fuel costs largely drove the 0.5 percent decline in the CPI for the December 2008 quarter, bringing annual inflation down to 3.4 percent. Expectations are for relatively low rises in the CPI for the next two quarters and that the CPI will be well within the Reserve Bank's target range of 1-3 percent by the end of this year. This is consistent with the forecasts from the banking sector outlined below which, on average, show inflation tracking down to around 2 percent in March year 2010 and remaining at similar levels for the March 2011 year.

The CPI tradable component decreased 2.1 percent in the December 2008 quarter (mainly as a result of a significant drop in fuel costs), but the non-tradable component increased 0.8 percent. For the year to December non-tradable inflation was 4.3 percent, the largest increase in three years. It reflected increased electricity charges, higher housing rentals, some earlier increases in cost of new housing and rises in local authority rates and payments. This highlights the importance of ensuring that domestically generated inflation is constrained through contestability in provision of goods and services currently subject to monopoly provision or limited contestability.

Given the declining labor market outlook, it is likely that restraint will be placed on wage demands as individuals and businesses adjust to tighter economic conditions. This includes elements in the public sector which have tended to lead the drive for increased salaries over recent years. This will allow the Reserve Bank greater freedom to reduce interest rates further without concern about refueling inflation.

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Mar 09	Mar 10	Mar 11
Highest	3.0	2.7	2.4
Average	2.9	2.3	2.0
Lowest	2.7	1.6	1.6

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

Labour costs – peaked and on the way down

Most recent outcome: +3.3% -- year-ended December 2008

The general pessimism about future labour market conditions is starting to impact on wage and salary rates, although by historical standards wage and salary rates achieved for the December quarter 2008 were still robust, although down substantially on the September 2008 quarter record growth in salary and wage rates.

The Labour Cost Index (LCI) recorded an increase of 0.7 per cent in salary and wage rates (including overtime) for the December 2008 quarter, down from a record 1.1 percent increase in the September 2008 quarter. On an annual basis the LCI showed that salary and wage rates (including overtime) were 3.3 percent higher in the December 2008 quarter than in the December 2007 quarter. This increase is down from a 3.6 percent annual rise for the September 2008 quarter (the largest since the series began in the December 1992 quarter).

The Quarterly Employment Survey (QES) recorded that seasonally-adjusted total gross earnings increased by 4.1 percent in the year to December 2008, but did not increase in the December 2008 quarter. This is the first quarter since June 1999 to show no growth in seasonally-adjusted total gross earnings.

Given the declining labor market outlook, it is likely that restraint will be placed on wage demands as individuals and businesses adjust to tighter economic conditions. This includes elements in the public sector which have tended to lead the drive for increased salaries over recent years.

Forecasts below show that total labour cost inflation is expected to decline over the next two years which is consistent with expectations of negative employment growth, rising unemployment, and reduced capacity utilisation.

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

	Years ending		
	Mar 09	Mar 10	Mar 11
Highest	3.6	2.8	2.1
Average	3.4	2.5	1.9
Lowest	3.2	2.0	1.7

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

Employment – official statistics….. and reality!

Most recent outcome: +0.9% -- year-ended December 2008

After a number of years of strong employment growth and reducing levels of unemployment, the tables have recently turned with expectations of negative employment growth out to 2011 and bank forecasts of unemployment to possibly reach 7 percent by March 2010 (see below).

Given the number of pessimistic business surveys on employment intentions, and the increased number of redundancies, it was somewhat surprising that some official statistics actually indicated employment growth over the December 2008 quarter. Our view is that such statistics need to be taken with a healthy grain of salt given the yo-yo outcomes of official quarterly employment data over the past year or so. The latest results simply don't stack up with the reality of the marketplace.

The Department of Statistics Household Labour Force Survey (HLFS) for the December quarter 2008 shows that the unemployment rate has risen from 4.2 percent to 4.6 percent. This resulted in the number of unemployed rising by 10,000 over the previous quarter. Despite the rise in unemployment, the number of people employed actually rose by 21,000 (0.9) over the December 2008 quarter, mostly driven by a rise in male part-time employment. Nevertheless, despite the rise in employment, total actual hours worked per week fell by 1.9 percent over the December 2008 quarter.

Forward looking indicators of likely labour market activity such as the NZIER's Quarterly Survey of Business Opinion (QSBO), and the Department of Labour's (DOL) Job Ads series show that the employment outlook has turned negative at a rather alarming rate.

The NZIER QSBO (January 2009) shows that a net 32 percent of firms intend to cut staff numbers over the next three months which is the highest rate since June 1991 (when unemployment coincidentally was at a peak of 11 percent).

As would be expected, there has been a notable easing in the difficulty of finding skilled and unskilled staff. A net 20 percent of firms reported that it had become easier to find skilled labour and a net 43 percent that it had become easier to find unskilled labour. These figures are the highest in 17 years.

The Westpac McDermott Miller employment confidence index collapsed in the final quarter of 2008, falling 17.2 points to a new survey low of 104.0. In the four and a half year history of the survey, the index has averaged a solid 128.2, and has never been lower than 120.8 (June 2008 quarter).

The Department of Labour's Job Ad Series shows that the Job Ad Rate (number of Job Ads/Number of employed, from the HLFS) continues to decline along with the number of job ads (both newspaper and Internet job ads). While it is important to clearly understand the caveats associated with this data, given that the Job Ad counts are derived from only 7 major regional newspapers and 4 major websites, the direction of the job ad rates is clearly down.

Forecasts: Unemployment % (HLFS)

	Quarter		
	Mar 09	Mar 10	Mar 11
Highest	5.2	7.2	7.3
Average	5.2	6.7	6.5
Lowest	5.1	6.1	5.6

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

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

Most recent outcome: 3.23% as at 25 February 2009

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 significantly since the last business forecast. Forecasts below point to further reductions in interest rates to hit a low of under 3 percent by March 2009, then showing a modest increase out to March 2011.

There is still continued talk in some circles that the Reserve Bank may make further cuts in the OCR (currently 3.5 percent) over the next few months. In the current climate, anything is possible. However, as mentioned earlier, further drops in the OCR will not necessarily flow through to an equivalent drop in the cost of capital to businesses given risk factors and the cost of banks borrowing on international wholesale markets.

Forecasts: Interest Rates (90 day bills)

	As at end of		
	Mar 09	Mar 10	Mar 11
Highest	3.1	4.9	6.5
Average	2.9	3.4	5.4
Lowest	2.7	2.7	3.9

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

Exchange Rates – bottoming out?

Most recent outcome: NZD = US$0.51.09 as at February 26 2008

NZD = AU$0.78.73 as at February 26 2008

TWI = 52.46 as at February 26 2008

The NZ dollar has taken a bath against the currencies of our major trading partners, and particularly the US. This is for a number of reasons, including declines in international commodity prices, rapid reductions in interest rates from previous highs, reducing incentives for investment in New Zealand, and concern about New Zealand's current account deficit, all of which are putting downward pressure on the dollar.

There is some tentative evidence that the NZ dollar may be nearing its lowest point over this cycle but we are in very uncertain times so anything is possible as can be seen from the forecasts below. Forecasts show very wide variations in exchange rates which in many respects reflects the continuing uncertain economic times facing many countries, not only New Zealand.

AUD (cents)			
	Mar 09	Mar 10	Mar 11
Highest	0.797	0.844	0.855
Average	0.788	0.800	0.815
Lowest	0.780	0.750	0.750

USD (cents)			
	Mar 09	Mar 10	Mar 11
Highest	0.510	0.650	0.650
Average	0.503	0.515	0.578
Lowest	0.500	0.410	0.480

TWI			
	Mar 09	Mar 10	Mar 11
Highest	51.7	65.1	64.6
Average	51.1	53.2	58.3
Lowest	50.8	43.9	51.9

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 although among developed countries, Australia has weathered the global financial crisis in reasonable health. The Australian economy is still growing, although slowly, and has not suffered the fallouts associated with banking collapses and major company failures.

Despite the above, the Australian Government on February 3rd unveiled an A$42 billion stimulus package. At the same time the Reserve Bank of Australia further reduced its benchmark interest rate by 100 basis points to 3.25 percent.

There is a question over whether the A$42 billion stimulus package is wise at this time but the Prime Minister Kevin Rudd stated that his government *"will move heaven and earth to reduce the impact of the global recession in Australia."* While some of the expenditure will certainly stimulate short-term demand, there has to be a major question mark over whether pumping $A 29 billion in infrastructure building (namely schools and public housing) in the next four years and $13 billion in cash handouts to low-income workers and farmers is the right way to go. Carefully targeted expenditure is probably desirable at this time but not general handouts across the board. The latest stimulus package comes on top of a $10.4 billion stimulus programme last October, which took the form of lump sum cash payments to pensioners and low and middle income families in the hope that it would trigger a quick recovery in consumption spending.

Despite the significant stimulus package there are worrying sings for the Australian economy. World demand for commodities has declined with a significant slowdown in China having a major impact on Australian exports.

The housing market is of concern given the strong increases over recent years with the possibility of a sharp fall in prices having a negative wealth effect and further dampening consumer demand.

2.1 Economic Growth (GDP)

Most recent outcome: +1.9% for the year ended September 2008.

Forecast 2009: +0.3%

Source: *The Economist*

Australia's annual GDP continues to ease, now below 2 percent. Forecasts point to further drops with growth negligible for 2009.

Some key recent economic statistics:

- New motor vehicle sales down 16.5 percent for January 2009 compared with January 2008.
- Dwelling unit approvals down 30.1 percent for December 2008 compared with December 2007.
- Employment up 1.0 percent for January 2009 compared with January 2008.
- Unemployment rate of 4.6 percent as at January 2009, up from 4.1 percent in January 2008.
- Participation rate of 65.0 percent as at January 2009, down from 65.2 percent in January 2008.

The Australian PMI continues to show contraction at a similar rate to New Zealand's PMI, currently sitting at 36.6 as at January 2009.

2.2 Headline Inflation

Most recent outcome: +3.7 per cent for the year ended December 2008

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 percent. Since then the Reserve Bank has continued to slash interest rates and currently the benchmark interest rate is 3.25 percent. Like New Zealand, inflation in Australia is likely to come back down from current levels to be within the Reserve Bank of Australia's target of between 2 and 3 percent. Nevertheless the recent stimulatory package may push up inflationary pressures to a degree in some sectors but this will be more than offset by declining commodity prices.

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 are being announced on an almost regular basis.

International economic growth forecasts are still being revised downwards in light of the continued slump in global demand for goods and services. The International Monetary Fund has recently revised the international growth forecast down from 2.2 percent in November 2008 to a new forecast of essentially zero growth for 2009. Already a number of developed economies including the US and Britain are in significant recession. The US economy is forecast to decline 1.8 percent, the UK 2.2 percent, Japan 1.7 percent and the European Union 1.3 percent. The expectation is that international growth will bounce back in 2010, although there are a number of factors that could adversely affect this.

United States

The US economy is going from bad to worse. American unemployment jumped from 7.2 to 7.6 percent in January 2009. Close to 600,000 staff were laid off in January after significant redundancies the previous month.

The repeated stimulatory packages appear to be having little if any effect and one must seriously question whether propping up banks and companies in comatose states is a wise option given the huge burden such bailouts will have on debt levels. The fiscal stimulus package and weaker economic situation will drastically increased the federal deficit

The Federal Reserve slashed interest rates throughout 2008 and the benchmark rate of 0.25 percent is now one of the lowest in the developed world. The Federal Reserve is expected to keep its interest rates at just above 0% for 2009 before tightening very slowly in 2010.

Average consumer price inflation is set to decelerate sharply in 2009 and remain subdued in 2010. The severe weakness of domestic demand and easing commodity prices will exert strong downwards pressure in US prices.

Output in the US is projected to be down 2.0 percent for 2009 after modest decline in the fourth quarter of 2008 of -0.2 percent. Such is the gloom and doom across the US, including in the domestic housing sector, that any tentative upturn would appear a long way off.

Euro zone

Economic reports coming out of the Euro zone confirm that the Euro area and its major trading partners are undergoing an extended period of economic downturn. As a result, inflationary pressures are continuing to diminish, allowing interest rates to come down substantially. However despite lower interest rates there has been a continued deceleration of credit growth in the euro area.

Foreign demand for Euro area exports has declined and domestic factors, including very low confidence and tight financing conditions, have impacted significantly on domestic demand.

The outlook is surrounded by a high degree of uncertainty but the overall risks point to economic growth remaining clearly negative for a number of quarters. The risks relate to the potential for a stronger impact on the real economy of ongoing turmoil in financial markets as well as the emergence and intensification of protectionist pressures.

In the United Kingdom real GDP is estimated to have declined by a significant 1.5 percent quarter on quarter in the December quarter of 2008. The decline was broad based across sectors, but reflected a further contraction in domestic demand. Confidence indicators suggest that output is likely to fall further over coming quarters.

In light of the pessimistic outlook the Bank of England decided to decrease its main policy interest rate by 50 basis points to 1.5 percent. The housing sector continues to languish with prices down around 16 percent for the year ended December 2008

Asia

Economic activity has continued to decelerate in Asia, driven by the common factor of reduced external demand which has affected exports and industrial production. Unemployment rates are increasing while inflationary pressures have moderated further thus allowing central banks to loosen monetary policy significantly.

While still boasting growth rates which are the envy of the developed world, China experienced a reasonable drop in activity in the last quarter of 2008, when the annual rate of real GDP growth dropped from 9 to 6.8 percent. The main driver of the slowdown was declining external demand.

Japan

Economic activity has declined significantly over recent times while inflation remains firmly under control. In fact annual inflation has declined to 0.4 percent on an annual basis. Given such low inflationary pressures and declining economic activity the Bank of Japan has left its benchmark interest rate at 0.1%.

In December 2008 industrial production posted a record month-on-month decline which followed the previous record fall in November.

Exports have contracted sharply, also showing a record decline in December.

Firms' investment intentions have slumped while private consumption has fallen, given household nervousness about job security in the light of a weakening labour market.

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