BUSINESS NZ

PLANNING FORECAST

MARCH 2013

BusinessNZ

NZ Economy – finely balanced

Executive Summary

A number of both positives and negatives are affecting the NZ economy at present, hence the title – NZ economy - finely balanced.

On the positive side of the ledger, a better international story is emerging with improving prospects for the world's largest economy, the US.

The latest Markit Global Business Outlook Survey of 11,000 companies found the number expecting business activity levels to rise over the coming year exceeded those expecting a decline by 39%, up markedly from a post-crisis low of 30 per cent seen in the previous, October 2012, survey.

International commodity prices, in general, remain firm, as reflected both in the ANZ Commodity Price Index and in the continuing upward movement of dairy prices evident from Fonterra's latest GlobalDairyTrade (GDT) auction. New Zealand's major trading partners continue to enjoy solid growth with exports from China showing strong growth of late and that country's GDP growth projected to be still in the 7-8 per cent range for the year. A number of Australian economic indicators are also showing improvement.

The Reserve Bank has signalled that interest rates are expected to remain at current levels at least until the end of the year, while the housing market is gaining momentum and the Canterbury rebuild is gathering steam, with more tradespeople moving into the area.

Consumer and business confidence surveys are buoyant and the latest BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and Performance of Services Index (PSI) are both clearly in positive territory.

Improved consumer confidence is to an extent likely to be driven by an improved housing market as well as by a slight improvement in labour market data – although the labour market is showing only a small improvement to date.

But there are a number of issues on the negative side of the ledger.

One of the key talking points of late has been the dry weather, with the whole of the North Island declared a drought zone. Much of the South Island is also very dry.

While the total cost of the drought to the NZ economy is at this stage largely based on guessimates, some commentators have suggested that it could knock around $2 billion off GDP.

The continued elevated state of the NZ dollar against the US is affecting some exporters, although the latest PMI shows that manufacturing activity rebounded strongly over the first two months of 2013, after relatively mediocre results for much of 2012.

Other key issues are looked at later in this report and include concern over some of government's regulatory decisions and the need to deal with land supply for new housing.

HIGHLIGHTS

The BusinessNZ Economic Conditions Index (ECI) sits at 18 for the March 2013 quarter, up 3 on the previous quarter and up 16 on a year ago.

NZ's major trading partners continue to show solid growth prospects with international commodity prices holding up reasonably well.

Business and consumer confidence surveys are positive, with survey results now backed up by solid data.

Despite both an improving outlook domestically and internationally, a number of risks remain.

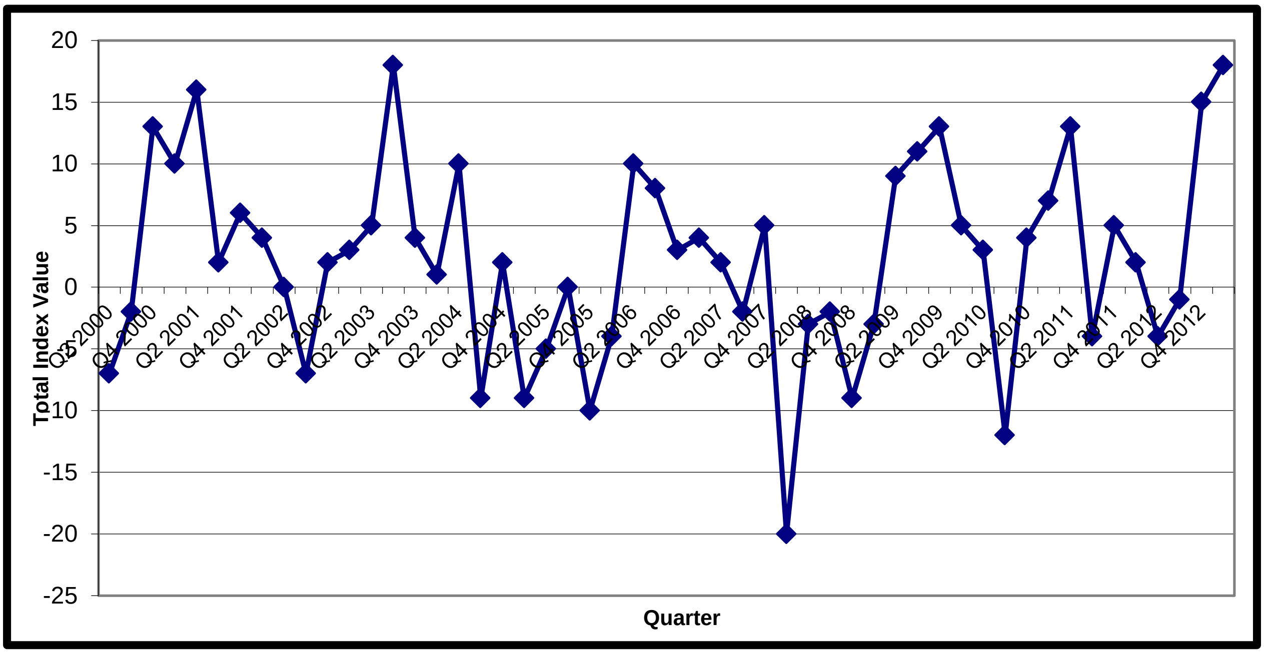
- **Ongoing drought conditions will have implications for NZ's growth prospects further out but short-term may result in higher output as farmers focus on reducing stock numbers.**
- **Household debt levels remain elevated after showing signs of improvement post-2008.**
- **There is an urgent need to address land supply in respect to housing affordability.**
- **Improvements are still required in government regulatory decision-making to ensure the benefits of regulation clearly exceed the costs, including unintended costs.**
- **Labour market outcomes are showing only small improvements of late, although surveys suggest a slight pick-up on the back of stronger manufacturing and services data.**

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 18 for the March 2013 quarter, up 3 on the previous quarter and an improvement of 16 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 2 for the March 2013 quarter, down 2 on the last quarter and up 2 on a year ago. An improved international outlook, with firming commodity prices, bodes well for exports despite ongoing concern from some quarters over the strength of the NZ dollar.

Monetary policy/pricing indicators sit at 3 for the March 2013 quarter, down 1 on the last quarter and up 8 on a year ago. Inflationary pressures in NZ remain subdued, with historically low interest rates likely to continue over the medium term. Nevertheless, inflationary risks will increase unless rapid action is taken to remove constraints on improving housing affordability.

Business/consumer confidence indicators sit at 7 for the March 2013 quarter, the same as for the previous quarter and as a year ago. Business confidence indicators show improvement particularly in construction, manufacturing and services. The agricultural sector, by contrast, is relatively subdued.

Labour market indicators sit at 6 for the March 2013 quarter, up 6 on the previous quarter and up 7 on a year ago. Forward looking indicators point to an improvement in labour market outcomes although it is a slow grind.

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[1] The ECI tracks 32 indicators on a quarterly basis. The overall index value for any particular quarter represents the net balance of the 32 indicators (generally the number increasing minus the number decreasing) thus providing an overall measure of performance. In general, increases in an indicator are seen as positive (e.g. growth in GDP or employment) and declines as negative. However, this is not always the case. For example, declines in unemployment are seen as positive and increases as negative.

PART 2: THE NEW ZEALAND ECONOMY – WHERE ARE WE GOING?

1.1 Economic growth (GDP) – a game of two halves

Economic growth is forecast to average around 3 per cent per annum out to March 2015, as outlined below.

Forecasts: Real GDP % Growth

	Years Ending		
	Mar 13	Mar 14	Mar 15
Highest	2.2	3.3	3.2
Average	2.2	2.9	3.1
Lowest	2.1	2.6	2.7

Source: ANZ, ASB, BNZ, and Westpac

There are a number of factors which, over the next few years, are likely to play out positively for economic growth. Conversely, there are also a number of risks to achieving better growth prospects.

On the positive side, a number of factors should continue to boost growth prospects.

Given NZ's dependence on exports, the state of the country's major trading partners is fundamental. In this regard, prospects are looking up with a number of surveys showing improved global sentiment.

Commodity prices in general remain firm, with the latest results from the ANZ Commodity Price Index showing that prices have increased for the seventh consecutive month - 9 per cent since the most recent low recorded in July 2012. However, to some extent the strength of the NZ dollar has offset much of the gain in world prices.

ANZ Commodity Price Index

	World Price Index	Annual % Change	NZ$ Index	Annual % Change
Feb 2009	171.1	-30.6	179.1	2.1
Feb 2010	242.4	41.6	189.0	5.5
Feb 2011	298.6	23.2	212.8	12.6
Feb 2012	290.0	-2.9	189.2	-11.1
Feb 2013	275.3	-5.1	177.6	-6.1

Source: The ANZ Commodity Price Index – 4 March 2013

The price of dairy products surged to its highest level in two years in Fonterra's latest GlobalDairyTrade (GDT) auction. The GDT-TWI Index rose 14.8 per cent compared with the last sale two weeks ago, the biggest increase since September 2010 and the seventh straight gain. The total volume of dairy products sold at the latest action was down considerably from earlier auctions, suggesting that production is being adversely affected by the current drought.

The rebuild of Christchurch, after significant delays, appears to be gathering momentum as outlined in a number of official and unofficial statistics. Beyond Christchurch there is also significant improvement in the housing market, particularly in Auckland as several years of pent up demand for housing are now being reflected in greater construction activity. Earthquake strengthening of buildings will also be an ongoing source of activity for a number of years to come although government policy proposals on improving seismic performance leave a lot to be desired. (See below).

Given consumer confidence is closely related to current and future employment prospects, at the moment, the drifting nature of labour market outcomes is perhaps adding to the caution evidenced in recent consumer behaviour.

On the negative side of the ledger, there are a number of concerns, some largely outside the immediate control of either the private sector or of government, such as the current drought. However, lessons need to be learnt in how better to manage risk – by individuals, households, the private sector, and the Government.

While the total cost of the drought to the NZ economy is at this stage largely based on guesstimates, some commentators have suggested it could knock around $2 billion off GDP.

While the implications for the agricultural sector are potentially very serious, particularly if capital stock has to be slaughtered because of a lack of rain, the drought issue is also affecting urban centres. Water restrictions are now widespread throughout the whole country.

The current drought raises some fairly fundamental issues about the management of New Zealand's water supplies and whether there are signals sent to, and incentives on, people to use water efficiently.

Most urban areas still treat water as a "free" resource and in the absence of volumetric charging and/or peak pricing to deal with specific dry periods such as New Zealand is currently experiencing, Councils and others responsible for supplying water have little information on which to base decisions as to capital expenditure and infrastructure development relating to water. It is ludicrous that a country with significant water resources cannot tap into and make greater use of such information in periods such as the present. However, this kind of approach would require both capital expenditure and incentives on those who use water so they know and pay for the full cost of their behaviour. The absence of sound pricing signals continues to lead to the imposition of ad hoc restrictions on water use as a means of rationing water as a commodity.

Another big issue and another risk is the potential for rising house prices to put pressure on the Reserve Bank to raise interest rates in response to increases in the Consumers' Price Index (CPI). It is therefore important to expose the real reasons for house price rises to ensure any artificial constraints on supply (such as regimented regimes in restrict to land supply) are removed.

The Government has just released a report on Auckland which suggests that available land for development will fall well short of what is required to meet future demand, while a recent Internal Affairs discussion paper on development contributions indicates that the average development contribution charge nationally has increased from $3,000 per section to $14,000 per section over the past decade, an increase of 360 per cent.

While there may be a place for development contributions in meeting the marginal costs associated with new developments, using such funds simply as a mechanism for financing unrelated infrastructure development is inappropriate and merely adds to building costs. It is timely that the Government is reviewing the role and scope of development contributions, given their increasing use by a number of Councils.

Clearly, the right tools are needed to deal with rising housing costs. It is not sufficient just to complain when, or if, the Reserve Bank raises interest rates in response to house price rises when much of the cost increase can be fairly attributed to central and local government inertia.

A third major risk is that associated with the political process and regulatory decision-making.

There are a number of instances where government is proposing to encumber businesses and certain sectors with significant extra costs even though cost/benefit analysis suggests the proposals will have significant *negative* net benefits (when both the costs and benefits are taken into consideration).

There was the much publicised "tax on carparks" which caused considerable resentment in a number of different sectors leading the Government, as a consequence, to abandon the proposal.

On a much a more serious scale, are proposals which would have much wider ramifications than carpark taxes and which simply defy logic.

The proposals outlined in an MBIE document on building seismic performance will require all non-residential and multi-unit, multi-story residential buildings that do not meet the earthquake strength of 1/3 of the new building standard to be demolished or strengthened within 15 years (5 years for assessments and 10 years to take the appropriate action). The benefit cost analysis states that costs will be $1.7 billion, and benefits only $37 million. This does not take any account of economic losses to commercial and industrial businesses and their capital. There is no mention of compensation for potential regulatory takings or any analysis of the potential economic implications for particular regions.

The regulatory impact statement (RIS) is sub-standard, dismissing, without adequate qualification, alternatives to legislative intervention such as more market-based approaches. The one-size-fits-all approach takes no account of the seismic risks of different regions and in BusinessNZ's view is way out of line in respect to other regulatory interventions targeted at reducing risk.

It is not only the private sector which has expressed some concern about the quality of regulation; the NZ Productivity Commission (NZPC) has similarly raised substantive issues which need to be addressed.

The NZPC's draft report on its current inquiry into Local Government Regulatory Performance[2] is very critical of central Government's processes for making policy and regulation. Their chapter in the draft report goes into a fair amount of detail, but the following quote is telling:

> *"The Commission has found a number of shortcomings in the way that regulations are made at the central level – these including a lack of implementation analysis, poor consultation and weak lines of accountability. While these shortcomings are not universal across all agencies, they are common enough to be of concern."*

Furthermore, the draft report outlined work conducted by Castalia Strategic Advisors in 2012, which found that only 36 per cent of the 42 RIS reviewed fully met Cabinet's quality requirements. Therefore, while the Government's priorities for growth have become a central point for policy development, there also needs to be a corresponding improvement in the quality of regulatory decisions so that the private sector can clearly see that the Government is heading in one growth direction.

[2] Towards Better Local Regulation: Draft Report (December 2012)

1.2 Monetary Conditions – little change likely

Interest rates – on hold

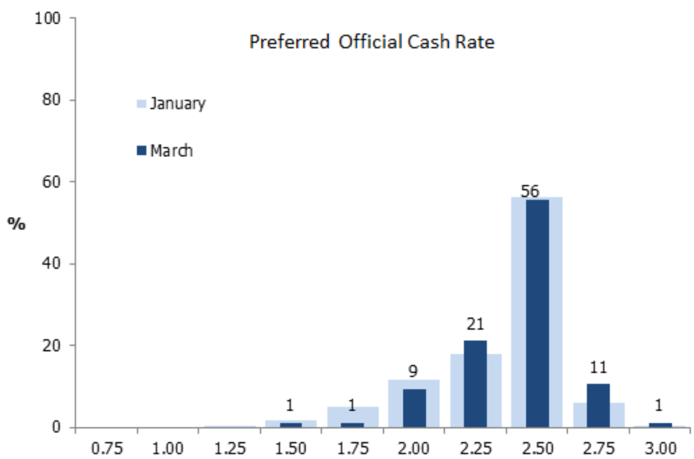
The 90-day bill rate is forecast to increase slowly to reach 3.3 per cent by December 2013 and 4.2 per cent by December 2014, as evidenced by the forecasts below.

With inflationary pressures (and expectations) at historic lows, the likelihood of any interest rate rises in the foreseeable future is very slim. In fact in the latest review of the Official Cash Rate (OCR), the Reserve Bank Governor went as far as to state that interest rates are likely to remain on hold until the end of this year. While most might not considered this an outlandish thing to say, historically the Governor of the Reserve Bank has tended to be extremely cautious in providing any view on interest rates beyond the very short term. Nonetheless, a more explicit statement on interest rates should provide greater certainty for markets, businesses and households, as to how interest rate changes are likely to evolve in the absence of any major external shocks.

The New Zealand Institute of Economic Research's (NZIER) Shadow Monetary Policy Board (whose task it is to recommend interest rate settings ahead of each decision by the Governor of the Reserve Bank of NZ) found the majority of its members still supported "no change" to the OCR.

On balance, keeping interest rates on hold has the most support from the Shadow Board while an interest rate cut has more support than raising interest rates. The economy is caught between two risks. Although drought will stifle production, rising house prices, fuelled by surging mortgage growth, present an upside risk to inflation.

NZIER *Shadow Board* continues to favour an OCR of 2.50%



Source: NZIER ***Shadow Board***

Forecasts: Interest Rates (90 day bills)

	As at end of		
	Mar 13	Mar 14	Mar 15
Highest	2.8	3.6	4.7
Average	2.7	3.3	4.2
Lowest	2.7	3.0	3.7

Source: ANZ, ASB, BNZ, and Westpac

The New Zealand dollar – continue at evaluated level for some time

Forecasts below show the NZ dollar remaining at elevated levels for at least the next year - particularly against to the $US, before falling somewhat by March 2015.

Forecasts: Exchange Rates

AUD (cents)			
	Mar 13	Mar 14	Mar 15
Highest	0.83	0.88	0.84
Average	0.81	0.83	0.81
Lowest	0.79	0.80	0.79

USD (cents)			
	Mar 13	Mar 14	Mar 15
Highest	0.85	0.85	0.80
Average	0.84	0.84	0.78
Lowest	0.84	0.83	0.74

TWI			
	Mar 13	Mar 14	Mar 15
Highest	76.5	78.9	73.9
Average	75.5	75.8	72.4
Lowest	74.3	71.6	70.1

Source: ANZ, ASB, BNZ, and Westpac

The major economies' ad hoc monetary policy interventions have, over recent years, made forecasting the direction of exchange rates even more difficult than it has been in the past. However, a relatively positive outlook for key international players such as the United States should see fewer wild exchange rate fluctuations, although the $NZ is likely to remain elevated at least in part owing to the easing of global liquidity conditions and international investors recovering their appetite for risk. The persistent gap between domestic and foreign interest rates is also likely to have some impact on the exchange rate.

Inflation - subdued expectations

Forecasts outlined below show inflation is well within the Reserve Bank's target range of 1-3 per cent for the year to March 2014, although some pressure will start to build in 2014.

There are a number of factors keeping headline inflation at bay (for now):

- An elevated exchange rate, particularly against the $US is keeping any imported (tradable) inflationary pressures under control.
- The labour market is still relatively subdued with minimal pressures on wages overall.
- Capacity constraints are not yet a major problem, although pressure on housing resourcing is increasingly becoming an issue.
- Strong competitive pressures within the retail sector are keeping a lid on prices.
- Reduced demand from the agricultural community in general - the result of the country's ongoing drought conditions (despite recent rain) - is keeping a lid on expenditure.

On the other side of the ledger there are building inflationary pressures:

- Rising house prices and the expansion of mortgages will fuel inflationary pressures (a major reason why issues which affect housing affordability e.g. land supply, development contributions (and potentially building code standards) need to be urgently addressed).
- Proposals by government targeted at ensuring all earthquake-prone buildings are either demolished or reach one-third of the earthquake building standard within 15 years will require significant resources which, added to the Christchurch rebuild, will put notable pressure on the availability of skilled tradespeople. The sheer amount of work will stretch the ability of the sector, in the wider sense, to cope.
- Depending on the length and impact of the current drought, agricultural production could be curtailed towards the end of the 2012/13 season, putting upward pressure on households as a reduced international supply forces prices to rise (already becoming a reality).
- Insurance costs are also rising (across the board) reflecting the repricing of risk by international reinsurers, an issue for both businesses and households throughout New Zealand.

Overall, the picture for inflation is relatively benign over the short-term. Over the medium term, the risk of increased inflationary pressures would appear at this stage to be greater.

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Mar 13	Mar 14	Mar 15
Highest	1.1	1.9	2.6
Average	1.0	1.8	2.5
Lowest	0.9	1.6	2.3

Source: ANZ, ASB, BNZ, and Westpac

1.3 Business and consumer confidence – positive

Business confidence – overall positive

Business confidence has continued to improve as evidenced by a number of surveys.

The ANZ Business Outlook shows that a net 39 per cent of respondents expect business conditions to improve over the year ahead, representing a 19 months' high.

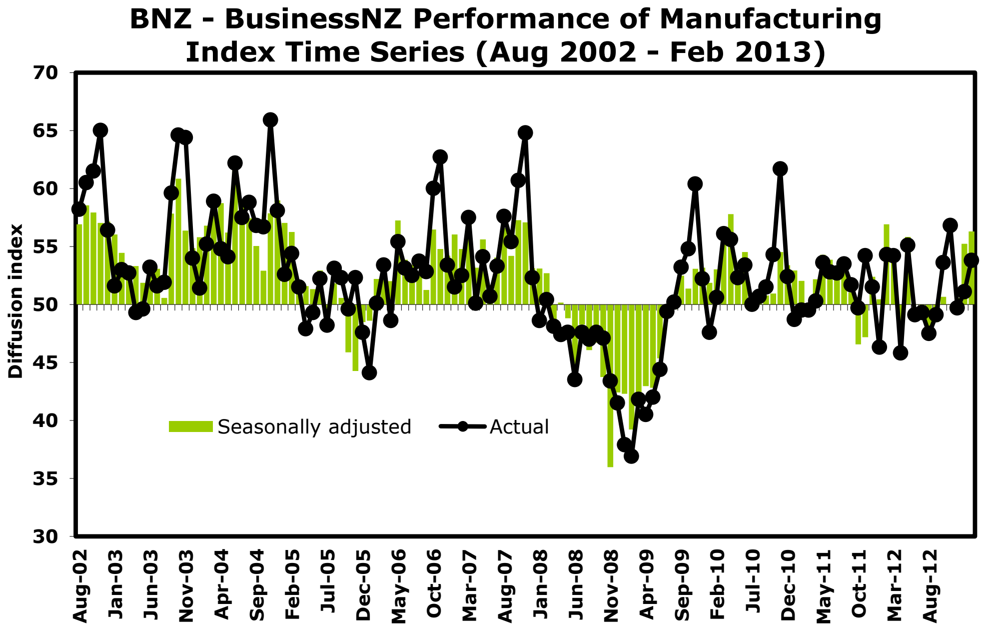
More importantly, firms' own activity expectations are strong with a net 38 per cent expecting more activity over the coming year.

Most of the survey's key components showed positive movement with export intentions, which continue to languish (a net 13 per cent expect a rise - the historic average is 32) the only fly in the ointment. To some degree this likely reflects the impact of a relatively high dollar, which is impacting on some exporters, particularly those largely exposed to the vagaries of international commodity markets.

The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) has shown strong expansion in early 2013.

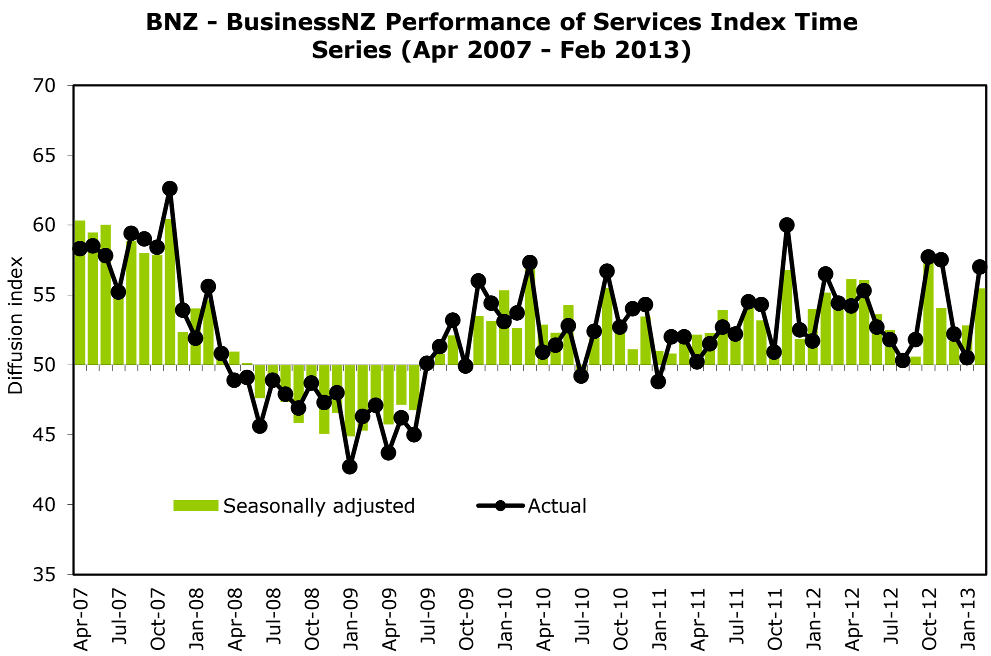
The seasonally adjusted PMI for February stood at 56.3, 1.1 points up from January and the highest monthly result since February 2012. Compared with previous February results, the 2013 value was close to that of 2012 and higher than values from 2006-2011. A PMI reading above 50 points indicates manufacturing activity is expanding; below 50 indicates it is contracting.

All five seasonally adjusted main diffusion indices were in expansion for February, the first time since May 2012. *Production* (61.4) led the way with its highest result since December 2004. This was followed by *new orders* (58.2), which recorded its strongest result since February 2012. *Employment* (50.1) did not display contraction for the first time since May 2012, while both *finished stocks* (51.8) and *deliveries* (53.9) both fell back from January levels of expansion.



Source: BusinessNZ

The service sector continued to show a pick-up in expansion, according to the BNZ - BusinessNZ Performance of Services Index (PSI).



Source: BusinessNZ

The PSI for February was 55.5. This was up 2.7 points, following a 1.1 increase in January. Compared with previous February results, the 2013 value was the highest since the survey began in 2007.

Expansion generally was across the board, with the main diffusion indices all showing stronger growth. In addition, the proportion of positive comments from respondents (64.8%) increased markedly from January (52.7%), with the country's current long fine period accounting for the largest proportion of comments on increased business activity.

The seasonally adjusted BNZ - BusinessNZ Performance of Composite Index or PCI (which combines the PMI and PSI) for February saw both options for measuring the PCI expand for the second consecutive month. The GDP-Weighted Index (55.5) increased 2.2 points from January, while the Free-Weighted Index (55.9) rose 1.7 points over the same period. This was the highest result for the GDP measure since October 2012, and the highest for the Free-Weighted measure since May 2012.

All five main sub-indices were in expansion during February, compared with two the previous month. Again, leading the way was new orders/business (59.6), while activity/sales (55.4) also experienced an increase from January. Employment (52.5) picked up 2.4 points from the previous month, its highest result since April 2012. Stocks/inventories (53.3) also produced its strongest value since April 2012, while supplier deliveries (55.8) increased significantly, reaching its highest value since June 2007.

All activity by region was in expansion mode during February and in the North Island, the Northern region (56.5) picked up 5.6 points after two consecutive months of slipping expansion levels. However, the Central region (54.5) produced an all but identical result from January. In the South Island, the Canterbury/Westland region (59.1) experienced its third consecutive increase in activity to record expansion for the current month, while the Otago/Southland region (61.9) bounced back after a dip in January.

Other sectors remain mixed. Residential and commercial construction is showing signs of improvement on the back of strong demand in Auckland and the continuing rebuild of Christchurch, while the agricultural sector is somewhat pessimistic, with Federated Farmers' Mid-season Farm Confidence Survey (January 2013), undertaken before the recent drought really kicked in, showing a general lull in confidence, excluding the generally more upbeat dairy sector. However, with the drought really starting to bite, even the dairy sector will have taken a hit and there have been a number of reported cases of cows being dried off for the season – a couple of months sooner than normal. For some farmers lost production and increased (supplementary) feed costs will impact adversely on farm incomes and ultimately mean reduced activity in the rural community. However, short-term production is likely to be up as a consequence of the need to slaughter stock early as drought conditions intensify.

Consumer confidence – solid

Consumer confidence remains in positive territory with consumers showing a slightly increased propensity to open their wallets.

The latest Westpac McDermott Miller Consumer Confidence Index for the first quarter of 2013 sits at 110.8, down very marginally (0.3) on the fourth quarter of 2012.

Given consumer confidence is closely related to current and future employment prospects, the relatively stagnant nature of labour market outcomes at the moment is probably keeping consumer behaviour in check.

Consumer expenditure is up slightly, perhaps taking advantage of a relatively high NZ dollar which is keeping a strong lid on price increases.

One risk is that households are perhaps taking advantage of historically low interest rates to expand consumption and so are adding to household debt levels.

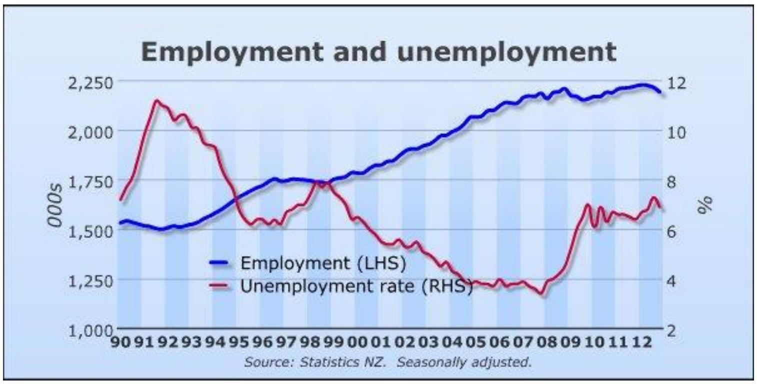
While households took the axe to debt post the 2008 global financial crisis, there is evidence that debt levels are starting to rise again, scary stuff given that interest rates have clearly bottomed out. As interest rates will inevitably rise over the next couple of years, it is likely that some households will be caught short with increased interest (debt servicing) payments.

1.4 Labour market – prospects improving

Employment – looking up

Unemployment is expected to continue to reduce over the next 2 years to reach 5.6 per cent by March 2015 (see below).

While the Household Labour Force Survey (HLFS) tends to bounce around somewhat, the latest PMI and PSI surveys (for the month of February 2012) show that employment in both the manufacturing and services sectors is showing some improvement having been more or less static for much of 2012. The PSI employment index is in positive mode (52.7), its highest level since April 2012, while the PMI is slightly in expansion (50.1), also its highest level since April 2012.



Other forward-looking surveys of employment confidence, including the ANZ's Job Ads series and the Westpac McDermott Miller Employment Confidence Index, show a rather tentative labour market.

The ANZ Job Ads shows a slight fall in Job Ads (1.5 per cent) in January, following a 0.4 per cent rise in December, suggesting a relatively static outlook for the unemployment rate from the previous month. However, this follows on from a 3 per cent drop in September.

While there are some conflicting results in respect to the strength of employment growth in Canterbury, in the last few months the number of migrant arrivals has increased and there is now a net inflow of migrants. This net gain is mostly accounted for by construction workers and is the direct result of the rebuilding occurring in Christchurch.

Forecasts: Unemployment % (HLFS)

	Quarter		
	Mar 13	Mar 14	Mar 15
Highest	7.1	6.6	6.2
Average	6.9	6.2	5.6
Lowest	6.7	5.8	4.8

Source: ANZ, ASB, BNZ, and Westpac

Labour costs – stable

Given a rather subdued outlook for labour market activity it is not surprising that the forecasts below indicate that labour costs are expected to increase only slowly to around 2.4 per cent for the year ending March 2015. This is very much in line with the long-run average for the Labour Cost Index and is up slightly on recent annual increases which have averaged around 2 per cent. Forecasts largely reflect the slight pick-up expected in labour market outcomes predicted over the medium term.

Private sector salary and wage rates (including overtime) increased 2.0 per cent in the year to the December 2012 quarter. Public sector salary and wage rates (including overtime) increased only 1.5 per cent in the year to the September 2012 quarter. The latest annual wage growth in the public sector was the result of growth in both central government (up 1.4 per cent) and local government (up 1.9 per cent).

While there will undoubtedly be some upward wage pressure in particular sectors (e.g. in the trades sector and associated services involved in the Christchurch rebuild), not surprisingly, given the general state of the labour market, overall, wage pressures appear to be modest.

Forecasts: Labour cost index per centage change (wages & salaries)

	Years ending		
	Mar 13	Mar 14	Mar 15
Highest	2.0	2.8	2.7
Average	1.9	2.2	2.4
Lowest	1.6	1.5	2.1

Source: ANZ, ASB, BNZ, and Westpac