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Business Planning Forecast

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Executive summary – economic outlook still positive despite recent international jitters

Economy

A number of indicators show the New Zealand economy is continuing to perform at reasonable levels despite recent jitters in international markets. Commodity prices are up while the recent significant drop in the $NZ is good news for many exporters hard hit from an over-inflated currency. But the recent significant drop in the dollar from its dizzy heights is a mixed blessing. On the positive side, commodity traders will receive a double boost with high commodity prices and a reduced dollar combining to bolster returns. Fonterra is now likely to revise upwards its projected payout for the 2007/08 season – the icing on the cake for rural communities. Manufacturers exporting into Australia will also breathe easier as the $NZ dollar moves downwards.

On the other hand, the 10-15% reduction in the value of the $NZ against most of our major trading partners signifies an effective reduction in New Zealanders' net wealth.

Inflationary pressures could arise from the recent drop in the dollar, with imported inflation becoming an issue. Already petrol prices have risen in response to the drop in the dollar although there will likely be some lags before a wider array of increased prices impact on consumers as existing stocks run down.

Recent rises in interest rates appear to be dampening consumer spending. The long awaited slow-down in housing is now evident, not so much in terms of house prices, which are still robust, but by the number of days taken to sell property. However, household consumption is still being underpinned by a continued strong labour market which sees unemployment at historical low levels, with solid employment growth.

About the Business Planning Forecast Report

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

HIGHLIGHTS

- **Despite more general pessimism about future economic conditions for the economy as a whole, both businesses' and consumers' perceptions of their own personal and business situations are still reasonably positive**
- **World commodity prices are still booming - good news for New Zealand commodity producers, particularly dairy**
- **Inflationary pressures are likely to persist with tradables inflation becoming an issue as the dollar dives**
- **Household consumption is beginning to ease as higher interest rates start to bite; high debt levels are likely to put some households under severe pressure over coming months**
- **Labour market conditions remain tight with little room for further expansion, given slowing net migration inflows**

Part 1: The New Zealand Economy

1.1. Economic growth (GDP) – modest improvement expected

Most recent outcome: 1.7% for the year to March 2007.

Gross Domestic Product (GDP) is a measure of a country's total economic activity over a given period. Since 2000 New Zealand's annual GDP growth has averaged over 3%, indicating a strongly performing economy with higher growth than in many other developed countries. However, that growth has now severely slowed, reaching only 1.7% for the March 2007 year.

Quarterly results show economic activity increased 1.0% in the March 2007 quarter, following an increase of 0.8% for the December quarter and 0.3% for the September quarter. Since March 2004, only two quarters (June 2005 and March 2007) have shown growth at 1% or more.

While there has been some rebalancing of late, the nature of output growth in New Zealand is still a cause for concern, with household consumption expenditure up 2.2% for the March 2007 quarter, following an increase of 1.4% in the December 2006 quarter.

Despite concerns over the value of the $NZ until recently, the manufacturing sector is still performing reasonably well by most measures. Goods-producing industries increased output by 1.7% for the March 2007 quarter, with manufacturing and construction industries up 1.1% and 2.6% respectively. Business NZ's Performance of Manufacturing Index (PMI) shows manufacturing continuing to expand, with the index reaching 54.6 for July 2007.

The outlook is still positive, particularly with the world commodity boom suiting New Zealand's commodity producers, and with expectations that Fonterra will boost its payout to dairy farmers for the 2007/08 season well beyond the $5.53 proposed recently; final payouts will of course depend on previous hedging arrangements.

The current account deficit, which sat at 9.7% of GDP in the year to June 2006 has improved to reach 8.5% for the March 2007 quarter on the back of strong prices for dairy products in particular. The potential exists for further significant reductions in the current account deficit provided international commodity prices remain high as expected, and the $NZ remains at current levels, or falls further, over coming months.

Expectations are that GDP will increase over the forecast period, as shown in the table below. However, growth levels of 2-3% are still below those of our major trading partners and well below those needed to propel New Zealand back into the top half of the OECD.

Forecasts: Real GDP % Growth

	Years Ending		
	Sep 07	Sep 08	Sep 09
Highest	2.9	2.7	3.2
Average	2.6	2.2	2.6
Lowest	2.4	1.3	2.3

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

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

Interest rates – still high and no early relief in sight

New Zealand's Official Cash Rate (OCR) is still very high by international standards, and is expected to remain at current levels for some time, with continued inflationary pressures in the economy. While the UK and Australia may raise their official interest rates further, the gap between New Zealand and our major trading partners continues to be significant.

While concerns over household consumption drove the Reserve Bank to increase interest rates to their new high of 8.25%, the concern now for the Reserve Bank is to contain inflation as the $NZ drops. This means high interest rates for the foreseeable future and no early relief in sight for businesses or households. While headline (measured) inflation is likely to fall outside the Reserve Bank's target band of 1-3% for the next year or so, the Reserve Bank has the ability to 'look through' the impact of one-off to keep its focus on price stability over the medium term. This will be no easy task.

Official Interest rates

Central Bank	Current rate (%)	Previous rate (%)
Reserve Bank of Australia	6.50%	6.25%
US Federal Reserve	5.25%	5.0%
Bank of England	5.75%	5.5%
European Central Bank	4.00%	3.75%
Reserve Bank of NZ	8.25%	8.0%

Despite the view that the OCR has peaked, there are several inflationary concerns still prevalent both internationally and domestically.

On the international front, New Zealand will be affected by imported inflation as the dollar falls. While New Zealand's higher dollar until recently cushioned households and businesses from international oil price rises, increased prices are now impacting on consumers and businesses as importers hike their prices on the back of a lower dollar.

On the domestic front, the labour market is still performing at close to capacity and, with lower net migration, means there is little available further labour that can be deployed. This obviously has implications for wage demands as markets respond to normal supply and demand conditions.

The New Zealand Dollar – anyone's guess?

Our analogy of someone firing arrows at a dartboard to try to predict the short-term direction of the NZ dollar continues to be bang on the money.

The first half of 2006 saw a steady drop in the value of the New Zealand dollar. The general consensus was that it had been too high for too long. Many believed that as the steam started to go out of the New Zealand economy, so would demand for the dollar, and increasing interest rates offshore would lure investors elsewhere. However, from August 2006 onwards that view changed, with the $NZ's relentless march upwards against all major currencies, eclipsing all the fall experienced during the first half of 2006. It has only been in the last 3 weeks that the dollar took a significant tumble.

While it is difficult to determine the short-term destiny of the $NZ, it is possible that the substantial drop, around 15% against the $US so far, will be as far as it goes with some support for the view that the $NZ will stay at high levels by historical standards for some time yet.

There are several drivers likely to support the higher dollar. Higher commodity prices have helped underpin the dollar while higher real interest rates compared with our major trading partners have acted as a supporting prop. International investors flooded into New Zealand with the expectation of high returns, apparently ignoring the potential for a significant drop in the NZ dollar which would erode any gains from higher interest rates. Now a more cautious approach, possibly intensified given potential losses from the US sub-prime housing market, is likely to lead investors to realign their investments away from the $NZ.

Despite the recent flight away from the $NZ, it is likely it will remain well above its long-term average, around 60 cents against the US dollar. A slow drift down from current levels (US 70 cents) is likely, although the reef fish syndrome could bring further volatility over coming weeks. Nevertheless, despite the recent hype about international shares and currencies, the latest movement fundamentally reflects a correction in analysis of risk rather than any major meltdown of world financial markets. The world economy is still in good heart and New Zealand is in a reasonably sound position to take advantage of this.

Net migration flows – continuing to slow

Over the last four years large migration inflows have boosted domestic consumer spending, car sales and house building. Migration has also helped mitigate some of the pressures that have built up in the labour market.

The annual net migration gain peaked at +42,500 for the year ended June 2003, fell as low as a +6,000 gain for the year ended October 2005 and then regained some momentum in 2006 to reach an annual gain of 14,800 by November 2006. However, since early this year net migration figures have drifted downwards, not significantly (to 9,000 for the year ending July 2007) but, as a good leading indicator of economic activity, enough to suggest that the economy is likely to meander along for the next two to three years.

A slowdown in net migration is a mixed blessing. On the one hand reduced net migration will help take some of the heat out of the property market as the demand for housing moderates. On the other hand it can reduce the skills capacity in the economy and restrict output growth. Many businesses are still short of skilled staff, reducing their capacity to meet demand and putting added pressure on prices.

Commodity prices – world and NZ dollar commodity price indexes continue to expand unabated

The continued surge in international dairy prices has underpinned a strong rise in the ANZ World Commodity Price Index over the last year. Dairy products account for nearly a third of the ANZ index, and have pushed up the overall index by 4.7% for the month to reach a new record high of 205.7 for July 2007. The overall index is now 35% higher than a year ago, the strongest annual percentage increase since the start of the series over 20 years ago. The latest rise in the index was again driven by increasing dairy prices which have more than doubled from a year earlier.

When converted into $NZ, the ANZ NZ Dollar Commodity Price Index rose a modest 1.1% in July 2007 to reach 142.7 – an annual increase of just 7.5%, demonstrating that while international prices increased strongly over the year, these gains were almost totally wiped out when converted into NZ dollars. On the other hand it also shows that strong international commodity prices are acting as a useful buffer for some industry sectors against the high NZ dollar.

Given the recent drop in the dollar over the last three weeks, New Zealand producers can look forward to reasonable if not spectacular increases in returns over coming months.

	World Price Index	Monthly % Change	Annual % Change	NZ$ Index	Monthly % Change	Annual % Change
July 2002	112.3	-0.4	-10.3	120.8	2.4	-21.9
July 2003	120.0	0.7	6.9	107.5	-0.7	-11.0
July 2004	149.3	0.5	24.4	123.7	-2.4	15.1
July 2005	155.3	-0.5	4.0	121.3	3.4	-1.9
July 2006	152.3	0.5	-1.9	132.7	0.9	9.4
July 2007	205.7	4.7	35.1	142.7	1.1	7.5

Source: ANZ Commodity Price Index NZ – 7 August 2007

Business confidence – lower but mixed signals evident

Despite pessimism about future economic conditions for the economy overall, both consumers' and businesses' perceptions of their own personal and business situations are still reasonably positive which suggests a slight decoupling of perceptions of the economy and reality.

The NZIER's Quarterly Survey of Business Opinion shows business confidence diving again after having stabilised in the March quarter. Here there is a clear decoupling of expectations about the economy in general and businesses' own activity levels. In this respect, the apparent significant decline in overall business confidence should be taken with a grain of salt.

On a seasonally-adjusted basis, a net 30% of firms expect the general business situation to deteriorate in the next six months. This compares with a net balance of 9% in the March 2007 quarter.

A more reliable indicator of business confidence is the activity levels of individual firms, and the June quarter results show confidence among firms actually improved. On a seasonally-adjusted basis, the net balance of firms reporting an increase in their own activity was 13%, up slightly on the 10% recorded in March. Perhaps even more importantly, a net 13% of firms recorded that they expect their own trading activity to lift in the next three months from its level in the June 2007 quarter so these results should certainly not be seen as all doom and gloom.

Sector performance and expected performance is mixed. The service sector continues to boom with a net 32% of respondents reporting an increase in volumes produced over the June quarter and a net 21% expecting volumes to increase in the September quarter. Other surveys, including Business NZ's Performance of Services Index which measures actual activity levels in the service sector, shows continued strength with the PSI sitting at 55.2 for July.

Manufacturing is mixed, with a net 6% recording a drop in output in the last three months while a net 9% expect an increase in output over the next three months.

The closure of a number of high profile manufacturers and decisions to manufacture off-shore are testament to the dollar's impact on some in that sector, although many of these moves would have likely occurred irrespective of where the dollar is at, given that they reflect more fundamental structural change as producers try and get production closer to their main markets.

Building and construction, and building materials suppliers all appear reasonably positive moving forward, although retailers may be expecting a squeeze on consumer spending over the next few months. Despite retail sales having bounced around over the last few months, taken overall the results are still reasonably strong by historical standards.

Consumer confidence – slipping

Consumer confidence continued to ease from earlier quarters dropping from 119.7 in the December 2006 quarter to 117.7 for the March quarter 2007 and 111.4 for the latest June quarter. While this fall partially reverses the sharp gain at the end of 2006, consumer confidence is still significantly higher than at the same time last year. An index number over 100 indicates there are more optimists than pessimists, while a number below 100 indicates that pessimists outnumber optimists.

In line with responses from the business sector, consumers appear much more pessimistic about the general economy than about their own personal situation. Seasonal factors may be at work here, with the fall in confidence appearing much more muted when seasonally adjusted (114.5), suggesting some of the drop can be attributed to winter blues.

The biggest impact on confidence came from declines in perceptions about the near term economic outlook, rather than a decline in perceptions about consumers' own financial situations. However increased debt servicing costs as a result of greater debt burdens and higher interest rates will likely dampen consumer confidence further out.

Household debt levels are currently sitting at 158% of disposable income and debt servicing costs are 13.3% of disposable income. Household debt levels and servicing costs seem to keep edging up without respite. While increasing debt levels have not been a particular problem given relatively low interest rates until recently, this will change as OCR hikes start to bite. Moreover the recent drop in the value of the $NZ will see added cost pressures flowing through to consumers.

The ASB quarterly NZ housing confidence survey shows that confidence of future rising house prices has declined from previous highs, although the survey points to a slowing in the momentum of growth rather than actual declines in house prices.

A still strong 47% of respondents believe that house prices will keep rising compared to 61% three months ago. About 15% of people believe that house prices will fall, compared with just 6 per cent three months ago.

While a slowing in market growth is increasingly evident, these results are still consistent with a soft landing.

1.2 Inflation – pressures persist

Most recent outcome: +2.0% year-ended June 2007

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 June quarter 2007 CPI rose 1.0% on the March 2007 quarter, bringing headline inflation down slightly from 2.5% annually to 2.0%. While tradables inflation is under control, largely because the high value of the NZ dollar is keeping imported inflation in check, the same can not be said for non-tradables inflation, which continues to give cause for concern.

In the June 2007 quarter non-tradable inflation increased to 1.1% following a 1.2% rise in the March 2007 quarter. This brings annual non-tradables inflation to 4.1% - a significant and ongoing issue for the Reserve Bank in containing inflationary pressures.

On the other hand, tradable inflation is under control, increasing 0.9% in the June 2007 quarter but sitting at -0.5% on an annual basis.

Given the resilience of the housing market and the ongoing buoyancy of consumer spending, the Reserve Bank and the Government should be concerned about the prolonged growth in non-tradeables inflation.

The big issue facing the Reserve Bank is how to deal with inevitable tradable inflation as the $NZ depreciates against the exchange rates of our major trading partners. Given that increases in the exchange rate over the last year have hedged New Zealand businesses and consumers against rising international oil prices, the potential for significant price increases as the dollar deflates will be a real issue. While the Reserve Bank has the capacity to 'look through' the impact of one-offs it will not be an easy task, particularly if individuals build in expectations that inflation is here to stay.

The Reserve Bank and to some extent the Government remain frustrated at the apparent lack of impact by interest rate rises on household behaviour; hence the continued search for supplementary instruments to control inflationary pressures.

Rising interest and exchange rates have prompted a number of proposals by commentators, ranging from mortgage levies to reduced interest rates. While some proposals may have superficial appeal, most have fundamental weaknesses when investigated further.

Business NZ's recent publication: *OCR: The Sharpest Tool in the Box? Giving interest rates some help to control inflation* has been submitted to the Finance and Expenditure Select Committee examining monetary policy. This publication offers a dispassionate view of potential support mechanisms to the OCR, recognising that there are no silver bullets.

Forecasts below show inflation likely to remain around the 2.5% mark for the next three years, picking up slightly in 2009. While this is within the Reserve Bank's 1-3% medium term range, it does not leave much leeway for any shocks or the potential flow-on effects of a declining $NZ. It is likely that inflation forecasts will be revised upwards as a result of the latest significant fall in the $NZ.

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Sep 07	Sep 08	Sep 09
Highest	2.2	2.9	3.3
Average	2.1	2.5	2.8
Lowest	1.9	1.5	2.5

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

1.3 Labour costs – wage pressures persist

Most recent outcome: +3.2% -- year-ended June 2007

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

Private sector salary and ordinary time wage rates, as measured by the Labour Cost Index, show an increase of 3.2% in the year to June 2007. This is the largest annual movement recorded for the private sector since the series began in the December 1992 quarter. Salary and wage rates including overtime increased 3.0 percent for the public sector in the year to June 2007. Forecasts below indicate that wage movements are likely to moderate, but only slowly out to 2009.

An alternative measure of labour costs is the Quarterly Employment Survey. This tends to be much more volatile than the Labour Cost Index, mainly because it reflects compositional changes in the labour force. Continued earnings growth is also evident in the Quarterly Employment Survey, with seasonally adjusted total gross earnings increasing 7.0 percent in the year to June 2007.

Future wage and salary movements are likely to be complicated by the progressive roll-out of Kiwisaver and its various permutations available to employers and employees. Also, given the relatively tight labour market, the potential exists for greater industrial action as already evident among both private and public sector employees in the health sector.

Forecasts: Labour Cost Index % Change

	Years Ending		
	Sep 07	Sep 08	Sep 09
Highest	2.9	2.8	2.8
Average	2.9	2.7	2.6
Lowest	2.8	2.5	2.3

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

1.4 Employment – remaining tight

Most recent outcome: +0.7% year-ended March 2007

The labour market continues to operate at close to full capacity given current constraints.

The latest Household Labour Force Survey shows seasonally-adjusted employment was up 14,000 for the June quarter (0.7%), while on the other side of the coin, the unemployment rate decreased marginally to 3.6%. The seasonally-adjusted labour force participation rate bounced back to an all-time high of 68.8%. Consequentially, in the absence of strong net migration flows, there is little more that can be squeezed out of the labour market in the short term. New Zealand effectively has full employment as measured in economists' terms.

There are a number of areas where it is difficult to attract appropriate staff. Job vacancy rates are still high and some businesses have given up traditional advertising, instead using word of mouth or non-traditional advertising such as placards outside their business.

While large migration inflows during 2003 and 2004 helped mitigate some of the pressures that built up in the labour market, increasing net migration - a leading indicator of future economic activity - has slowed. This leaves improved productivity as the only possible means to increase output.

Forecasts: Unemployment % (HLFS)

	Years Ending		
	Sep 07	Sep 08	Sep 09
Highest	4.0	4.3	4.5
Average	3.7	4.0	4.1
Lowest	3.3	3.5	3.4

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

1.5 Interest Rates (90-day bill rate) – continuing to climb

Most recent outcome: 8.99% as at 20 August, 2007

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

The impact of higher interest rates on households is likely to be significant, with floating rates likely to increase to around 10.5% over the next few weeks with fixed rates exceeding 9%. Few households are likely to risk entering into fixed rate mortgages for 4-5 years at such levels, so in the end, the Reserve Bank's slow march to raise interest rates is finally likely to have a significant impact on households over coming months. The days of shielding behind fixed rate mortgages are now over.

The latest rise in interest rates will likely see debt servicing costs rise to about 15% of disposable income by the end of the year, an increase of about 50% on three years ago.

While the forecasts below point to significant reductions in interest rates by 2009, this is not a forgone conclusion. Unless household consumption is brought under control and the housing market cools significantly, there is the possibility of interest rates remaining high for some time. This is further complicated by the fact that as the $NZ drops, the potential exists for imported inflation to enter the equation, with obvious consequences for interest rates as the Reserve Bank attempts to keep inflation within its target range over the medium term.

Forecasts: Interest Rates (90 day bills)

	As at End of		
	Sep 07	Sep 08	Sep 09
Highest	8.55	8.50	7.80
Average	8.52	8.36	7.07
Lowest	8.45	8.13	6.60

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

1.6 Exchange Rates – down, but how far and for how long?

Most recent outcome: *NZD = US$0.69.62 as at 20 August 2007*
NZD = AU$0.87.35 as at 20 August 2007
TWI = 67.57 as at 20 August 2007

The NZ dollar has slipped 15% over the last three weeks after rising significantly over the months of June and July. The TWI is now back at levels experienced in late 2006, while the NZ$: US$ shows a similar trend. Predicting exactly where the New Zealand dollar will head over the short term is akin to a random walk, especially as international currencies and stock markets are currently so volatile.

In the extreme short term, there are likely to be further downward pressures on the dollar as international investors take flight and return to safer currency options. On the other hand, record international commodity prices and a likelihood of interest rates remaining high in New Zealand should stop the dollar from slipping too much further at this stage. Clearly forecasts of exchange rates will be revised over the next few weeks in light of recent events.

AUD (cents)			
	Sep 07	Sep 08	Sep 09
Highest	0.934	0.850	0.850
Average	0.903	0.827	0.814
Lowest	0.885	0.770	0.797

USD (cents)			
	Sep 07	Sep 08	Sep 09
Highest	0.813	0.750	0.670
Average	0.788	0.685	0.625
Lowest	0.760	0.640	0.590

TWI			
	Sep 07	Sep 08	Sep 09
Highest	79.1	71.0	66.2
Average	75.6	66.8	62.5
Lowest	72.9	63.1	58.9

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. Secondly, it provides an indication of the likely strength of competition from Australian sourced products on the domestic market.

Despite moves by the Australian Prime Minister to appeal to a disgruntled electorate with tax cuts and spending sweeteners in the latest Budget, his Government is under pressure. However, growth prospects are still good with solid employment growth and lower unemployment rates. Inflation continues to be an issue with the Reserve Bank of Australia recently increasing the cash rate to 6.5%.

2.1 Economic Growth (GDP)

Most recent outcome: +3.5% for the year-ended March 2007.

Forecast 2007: +3.5
Source: *The Economist*

Australia's annual GDP increased to 3.5% in the March 2007 quarter, up from 2.4% recorded in the year to December 2006. Forecasts point to increases in growth, with a growth rate of 3.5% tipped for 2007 slowing slightly in 2008.

Some key recent economic statistics:

- Real retail sales up 6.3% in June 2007 compared with June 2006.
- New motor vehicle sales up 9.1% for June 2007 compared with June 2006.
- Dwelling unit approvals down 3.2% for June 2007 compared to June 2006.
- Employment up 2.6% for July 2007 compared to July 2006.
- Unemployment rate of 4.3% as at July 2007 – down from 4.8% in July 2006.
- Company profits before tax up 4.3% for May 2007 compared to May 2006.

The latest Australian PMI results (July 2007) show that Australian manufacturing is currently ahead of New Zealand's activity levels. The PMI is currently at 57.4 (seasonally-adjusted) compared with New Zealand's 54.6.

2.2 Headline Inflation

Most recent outcome: +2.1% for the year-ended June 2006

Forecasts: Mid 2007: 2.3%
Source: *The Economist*

Inflation in Australia has recently dropped after reaching a peak of 4% for the year to June 2006, which included the impact of increasing fuel prices.

After holding interest rates at 5.25% for a long period, the Reserve Bank of Australia lifted the cash rate to 5.5% in March 2005 and has subsequently moved it up another four times. This brings the cash rate to 6.5% with the potential for further rises.

Part 3: Rest of the World

The economic picture for the rest of the world is very important for New Zealand. Over recent quarters growth in the world economy has picked up, which will lift demand for New Zealand products and commodities. The recent jitters in international financial markets have resulted in a move towards more cautious investments. Investors are increasingly factoring in risk margins that will result in the cost of capital increasing from its recent lows. Volatility is likely to be the catch cry in the world's economy for some months ahead. However this is a correction in world markets rather than any sort of global meltdown of financial markets.

United States

Nervousness surrounding "sub-prime mortgages" has created increased instability as the institutions subject to such risks reassess their portfolios.

The Federal Reserve last week cut the discount rate charged on direct Fed loans to banks by 0.5% to 5.75. This differs from the main Fed funds rate which remained unchanged. This somewhat surprise move was targeted towards ensuring the free flow of funds in the financial system and avoiding a credit crunch. In effect the Fed is setting aside concerns over short-term inflationary pressures and opening the door for a potential cut in the Federal Funds rate to support growth.

This cooling, and added uncertainty of defaults on mortgage repayments in housing, may in fact leave room for one to two 25 basis point cuts in the Fed benchmark later this year.

The PMI stood at 53.8 for July. Consumer spending is unlikely to fare as well in 2007 as it did in 2006 given the housing market downturn.

Real GDP growth is forecast to meander along at around 2-2.5% for the remainder of 2007 and into 2008.

Europe

The big three Eurozone countries reported second quarter GDP results recently. Both French and German real GDP expanded just 0.3% quarter on quarter, down from 0.5% recorded in the first quarter of this year. Italy recorded negligible growth of 0.1% for the June quarter. These were all below the consensus forecasts. Eurozone real GDP is now 2.5% year on year compared with 3.1% year on year in the first quarter of 2007.

While the latest results indicate a softening in output, sentiment still remains at high levels. The Eurozone's economic sentiment indicator, usually a good indicator of future growth, shows no sign of reducing. The big risk is that the global liquidity contraction will hit the real economy next year. Even in that unlikely event, Europe will likely suffer less of a slowdown than the United States.

Japan

Overall, Japan has tended to be in the doldrums in recent times due to a consumption-led downturn, with both consumer spending and confidence levels pointing downwards. GDP growth currently stands at 2.6%, and is expected to remain around the current rate for both the remainder 2007 and 2008.

Labour market developments have tended to be positive but containment in terms of wage growth continues. Japan's unemployment rate remains stable at around 3.7%.

China

Economic activity in China is showing no signs of slowing. Latest results show GDP growth at 11.9% over the June 2007 year, with industrial production increasing a massive 19.4%. Given increased output, it is perhaps not surprising that inflationary pressures remain relatively strong, but are expected to moderate slightly to 3.0% by 2008.

The main priority for the ruling Chinese Communist Party over the next year will be to maintain political stability in the lead up to the Olympic Games to be held in Beijing in August 2008.

The Government will continue in its efforts to rebalance the economy, attempting to make growth less dependent on exports and investment while introducing measures to boost consumption. The current account surplus is forecast to remain huge, equivalent to 10.7% of GDP in 2007 and 9.8% in 2008.

Forecasts: World GDP Growth (Selected Trading Partners)

Country	*Latest*	*2007*	*2008*
Australia	3.8%	3.6%	3.3%
Canada	2.0%	2.5%	2.7%
Japan	2.6%	2.6%	2.3%
United Kingdom	3.0%	2.8%	2.3%
United States	1.8%	2.0%	2.6%
Euro Area	3.0%	2.7%	2.3%

Source: Economist

Forecasts: World Consumer Price Inflation (Selected Trading Partners)

Country	*Latest*	*2007*
Australia	2.1%	2.3%
Canada	2.2%	2.4%
Japan	-0.2%	0.0%
United Kingdom	2.4%	2.4%
United States	2.7%	2.8%
Euro Area	1.8%	2.0%

Source: Economist