

# PERFORMANCE OF SERVICES INDEX



BusinessNZ 

## Weakness continues in the service sector

### Bank of New Zealand - Business NZ PSI for September 2008

- The Bank of New Zealand - Business NZ Performance of Service Index (PSI) displayed contraction for the sixth month running, with the September result (46.9) the second lowest monthly result since the survey began. It was 1.0 point below the result for August, and the second lowest result behind June. The September result was also a substantial 12.1 points down from the September 2007 figure.
- Four of the five diffusion indices that make up the PSI exhibited contraction during September, with *activity/sales* (43.9) continuing to show a weak result. *Employment* (45.8) also remains weak, with contraction now continuing for seven consecutive months. September also saw for the first time *new orders/business* (49.4) going under the no change level of 50.0, indicating difficult times may continue for some time yet. Of the other diffusion indices, *stock/inventories* (53.0) remained similar to August, while *supplier deliveries* (45.6) went back into decline.
- Activity by region showed a largely similar pattern to previous months. The *Northern* region (46.5) continued to slip slightly, with its second lowest result. The *Central* region (52.7) also experienced a dip from August, but remained in positive territory for overall activity. In the South Island, the *Canterbury/Westland* region (50.9) recovered somewhat from contraction in August, while the *Otago/Southland* region (37.0) plunged further into contraction from August, but not quite at the levels experienced in June.
- The various service sectors continued to be almost all in contraction mode during September, with only *health & community services* (50.4) just remaining in positive territory. After a slight recovery over July and August, *accommodation, cafes & restaurants* (35.2) slipped back to its second worst result. *Transport & storage* (36.8) also reverted back to a similar level in June, while *retail trade* (45.5) remained in contraction for the sixth consecutive month.
- All firms by employment size experienced contraction during September. Medium-large firms (51-100 workers) (44.2) reverted back to contraction after expansion in August, while both small-medium firms (11-50 workers) (46.1) and large firms (101+ workers) (47.3) remained below 50.0 for over three months. Lastly, micro firms (1-10 workers) (48.4) returned to activity levels experienced in June.
- The proportion of negative comments from respondents during September stood at 62.4%, which was a slight dip compared with those in August (64.7%). Interestingly, compared with the same time last year, activity for those with positive comments (3.2\*) worsened, and was the same as those with negative comments (3.2).

The Bank of New Zealand - Business NZ Performance of Services Index is a monthly survey of the services sector providing an early indicator of activity levels. A PSI reading above 50 points indicates services activity is expanding; below 50 indicates it is contracting.

#### HIGHLIGHTS

- ***The overall level of activity for the service sector remains weak, with the September result (46.9) the second lowest on record.***
- ***Activity/sales (43.9) remained in contraction, while new orders/business (49.4) went under the level of no change for the first time.***
- ***The Central region continued to lead regional activity, while Otago/Southland showed further weakness.***
- ***The proportion of negative comments from respondents improved slightly to 62.4%.***

**Next Bank of New Zealand - Business NZ PSI: 17 November 2008**

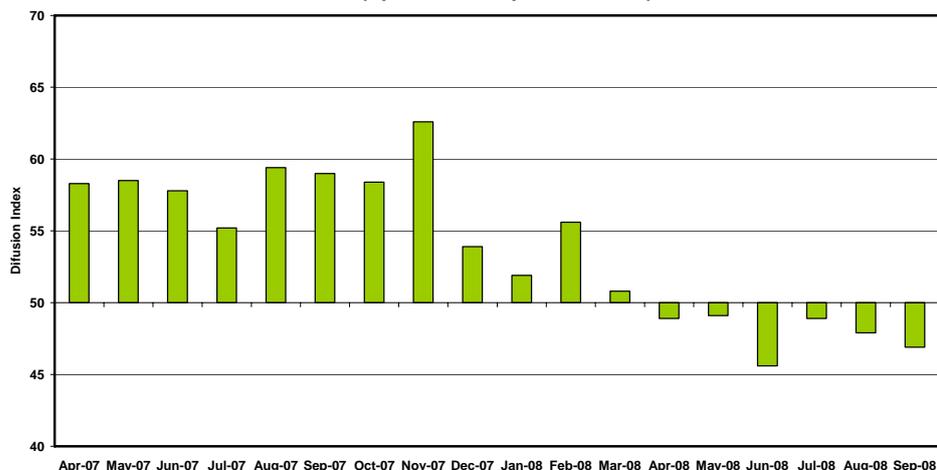
#### SPONSOR STATEMENT

Bank of New Zealand Ltd is delighted to be associated with the Performance of Services Index (PSI) and Business NZ. This association brings together the significant experience of leading business advocacy body Business NZ, and business finance specialist BNZ. We look forward to continuing our association with Business NZ and associated regional organisations, and to playing our part in the ongoing development of the New Zealand services sector.

Bank of New Zealand ([www.bnz.co.nz](http://www.bnz.co.nz))

\*Respondents are asked for a score from 1-5, where 1= large rise and 5= large fall.

**Bank of New Zealand - Business NZ Performance of Services Index Time Series (April 2007 - September 2008)**



## PSI time series tables

National Indexes	Sep 2007	May 2008	Jun 2008	Jul 2008	Aug 2008	Sep 2008
Bank of New Zealand - Business NZ PSI	59.0	49.1	45.6	48.9	47.9	46.9
Activity/Sales	60.7	49.0	44.9	47.9	41.2	43.9
Employment	53.1	46.8	41.8	47.5	48.1	45.8
New Orders/Business	65.4	54.8	51.4	52.7	50.2	49.4
Stocks/Inventories	57.1	47.1	46.6	46.7	53.2	53.0
Supplier Deliveries	56.8	44.8	42.7	48.2	51.3	45.6

Regional Indexes	Sep 2007	May 2008	Jun 2008	Jul 2008	Aug 2008	Sep 2008
Bank of New Zealand - Business NZ PSI	59.0	49.1	45.6	48.9	47.9	46.9
Northern	58.7	50.8	43.9	48.2	47.3	46.5
Central	56.5	50.5	47.9	54.9	55.4	52.7
Canterbury/Westland	61.2	50.6	51.1	51.1	47.7	50.9
Otago/Southland	61.9	41.6	36.1	40.4	39.3	37.0

### PARTICIPANTS

Business NZ gratefully acknowledges the participation of the following associations in contributing to the PSI:

- Employers & Manufacturers Association (Northern)
- Employers & Manufacturers Association (Central)
- Canterbury Employers' Chamber of Commerce
- Otago Southland Employers Association
- Hospitality Association of New Zealand
- New Zealand Retailers Association
- Tourism Industry Association New Zealand

## Substantial Rate Cuts Ahead

- Cash rate headed sub-neutral
- Financial gyrations not the cause
- But softening growth and inflation the drivers
- Inflation will drop sharply
- Credit rationing may be problematic for some

This Thursday should mark the continuation in what will be a series of substantial cash rate cuts by the Reserve Bank of New Zealand. Currently, folk seem to be preoccupied with trying to work out just how much the Bank will cut on October 23 but this is largely irrelevant. The issue of greater relevance is just how far rates will go over the longer run. In answer to this, we believe that the cash rate will fall to a low of around 5.0% before the cycle is over. Our current pick for the base is 5.25% but we acknowledge that there is substantial downside risk to this forecast.

In short, interest rates need to fall to at least neutral and, probably, below that point at the bottom of a significant economic cycle. Under normal circumstances we would suggest that neutral is around 5.5% to 6.0% but if the credit crisis continues in the manner that it is then neutral might be considerably lower given the large spread that exists between the official cash rate and the effective cash rate that banks are lending at, because of their difficulty getting funding. Normally, the difference between the two measures is negligible. Our forecasts thus assumes a return to credit market "normality" – whatever that means these days – within the next twelve months. However, we concede that, at this stage, there is nothing to support this view.

Notwithstanding this, we note that it is very important to judge future interest rate movements against the strength or otherwise of the real economy and accompanying inflation. It is far too easy to make outrageous statements in the hysteria surrounding current financial market volatility but it is only to the extent that this volatility tells you something about the fundamental macro indicators that one should be interested.

With this in mind, we can conclude that the outlook for the economy continues to deteriorate and, more importantly, inflationary pressures are shrinking rapidly.

And we say this fully cognisant of the fact that Q3's annual inflation, to be announced this Tuesday, will likely print in excess of 5.0%. But this is ancient history and we expect a substantial decline in inflation from here on in. Indeed, by September of next year, we believe annual inflation will be back within the Reserve Bank's target band on its way to a sub 2.0% low. Moreover, very low quarterly numbers can be expected for Q4 of this year and Q1 of next. We expect prices to rise just 0.2% in Q4.

Driving this process is a massive fall in commodity prices as global growth expectations falter; oil leads the way and petrol pump prices are down 17% from their peaks already. This has a major direct and indirect impact on domestic inflation. In addition, other commodity prices are dropping equally sharply. We are even informed by Fonterra that we can expect the shop price of dairy products to be falling by Christmas.

In addition to this, consensus forecasts for global growth are plummeting suggesting further disinflationary pressure ahead. To cap things off, domestic demand continues to wane implying that local inflation will also fall, especially for anything to do with the housing market.

This being so, the Reserve Bank now has the green light to push interest rates aggressively downward, so much so that we anticipate the cash rate will be somewhere between 1.25% and 1.75% lower within seven weeks.

Nonetheless, we caution businesses that they cannot expect lending rates to fall by the same magnitude. In the first instance, current lending rates already have priced into them a significant proportion of these expected cuts, which is why swap rates have rallied so aggressively over the last couple of months. Moreover, ongoing funding difficulties faced by the banking sector are likely to see a further widening in lending margins over the swap rate combined, potentially, and more worryingly from a wider economic perspective, with a modicum of credit rationing.

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