

PERFORMANCE OF SERVICES INDEX



Service sector activity contracts for the fifth consecutive month

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.

Bank of New Zealand - Business NZ PSI for August 2008

- The Bank of New Zealand - Business NZ Performance of Service Index (PSI) continued to show contraction in the service sector during August (47.9). It was 1 point below the result for July and the second lowest result behind June. The August result was also a significant 11.5 points down from the August 2007 figure.
- Although three of the five diffusion indices that make up the PSI showed expansion during August, the overall result was dragged down by a sharp drop in *activity/sales* (41.2). The previous lowest result for this index was June (44.9). *Employment* (48.1) also experienced contraction, but the August result was still the highest value since March. Of the remaining indices, *stocks/inventories* (53.2) and *supplier deliveries* (51.3) went into positive territory for the first time since February and March respectively, while *new orders/business* (50.2) was largely unchanged during August.
- Activity by region showed most to be in contraction. The North Island regions did not experience any significant change in activity from the previous month, with the *Northern* region (47.3) down 0.9 points from July, while the *Central* region (55.4) was up 0.5 points from July (largely due to strong sales/activity, employment and new orders/business). In the South Island, the *Canterbury/Westland* region (47.7) fell back into contraction after three months of slight expansion. Lastly, activity in the *Otago/Southland* region (39.3) remained similar to July, showing the lowest overall regional result for the fifth consecutive month.
- The various service sectors continued to be almost all in contraction mode during August, with the exception of *health & community services* (54.5) that has continued to remain in expansion since the survey began. *Retail trade* (43.2) indicated its lowest level of activity, while *wholesale trade* (46.5) returned to activity levels experienced in June. *Property & business services* (47.7) continued to remain in a fairly narrow activity range.
- By size of firm, both micro firms (1-10 workers) (45.4) and large firms (101+ workers) (43.9) fared the worst in August in terms of a decline in activity. In contrast, small-to-medium-sized firms (11-50 workers) (49.7) continued to improve with levels close to indicating no change. Medium-to-large firms (51-100 workers) (52.8) continued to rebound from a significant fall in activity in June to show expansion for the first time since March.
- The proportion of negative comments from respondents during August stood at 64.7%, which was almost equal with that received in July (64%). However, compared with the same time last year, activity for those with positive comments (2.3*) worsened, while negative comments (3.7) for August also showed a strong fall.

HIGHLIGHTS

- **The overall level of activity for the service sector remains in contraction, with the August result (47.9) the second lowest on record.**
- **Activity/sales (41.2) dived 6.7 points from July, which dragged down the overall national result.**
- **The Central region continued to lead regional activity, while Otago/Southland remained in contraction.**
- **The proportion of negative comments from respondents remained largely unchanged at 64.7%.**

Next PSI: October 20 2008

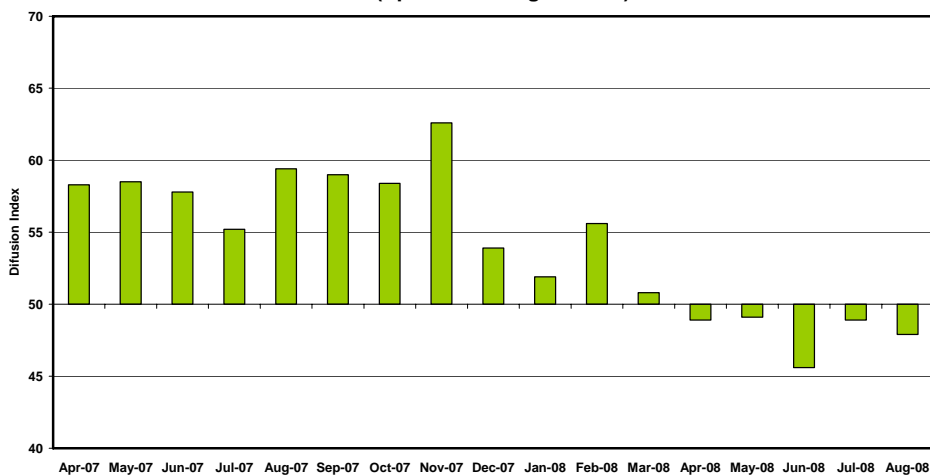
SPONSOR STATEMENT

Bank of New Zealand 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)

*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 - August 2008)



PSI time series tables

National Indexes	Aug 2007	Apr 2008	May 2008	Jun 2008	Jul 2008	Aug 2008
Bank of New Zealand - Business NZ PSI	59.4	48.9	49.1	45.6	48.9	47.9
Activity/Sales	63.5	48.3	49.0	44.9	47.9	41.2
Employment	54.4	44.7	46.8	41.8	47.5	48.1
New Orders/Business	65.4	55.3	54.8	51.4	52.7	50.2
Stocks/Inventories	50.6	46.9	47.1	46.6	46.7	53.2
Supplier Deliveries	56.5	47.8	44.8	42.7	48.2	51.3

Regional Indexes	Aug 2007	Apr 2008	May 2008	Jun 2008	Jul 2008	Aug 2008
Bank of New Zealand - Business NZ PSI	59.4	48.9	49.1	45.6	48.9	47.9
Northern	59.9	49.8	50.8	43.9	48.2	47.3
Central	58.2	53.8	50.5	47.9	54.9	55.4
Canterbury/Westland	59.4	48.1	50.6	51.1	51.1	47.7
Otago/Southland	58.4	42.8	41.6	36.1	40.4	39.3

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

Debt Funding Pressures Remain

- Combined PMI and PSI look ugly
- More evidence of negative Q3 GDP
- Surprise OCR cut offers some respite
- But bank funding pressures remain
- And regulatory shifts will boost borrowing costs

Like last week's PMI, the Performance of Services Index, continues to show a business community that is far from happy with its lot. Indeed, at face value, the combined outcome of these two surveys would portend an economy that remains moribund. Of particular concern was the extraordinarily low reading (41.2) for activity and sales which sits well with our view that Q3 will produce the third consecutive negative quarter of growth for the economy. Supporting this was the very poor retail sales data we got for July.

It is interesting to note that both the PMI and PSI have both retreated since the last rate cut by the RBNZ. In this regard it will be interesting to see if any optimism is forthcoming following last week's surprise slashing of the OCR by 50 basis points.

In theory, the slump in rates should be great news for corporate New Zealand but we remain wary that the ongoing funding pressures faced by the banking sector will result in a continued deterioration in lending conditions for many.

In the first instance, it is worth noting that while the cash rate was slashed by 50 points, longer dated swap rates moved much less on the day. Two year rates fell 18 points, five year 9 points and ten year just the one point. Thus the "base-rate" faced by the banking sector in its desire to provide longer dated funding moved little. There were three reasons for this. Firstly, financial markets had already priced in a 25 basis points cut so

only 25 of the 50 came as a surprise; secondly, the Reserve Bank's published forecasts, despite the aggressive initial move, actually have a higher end point to their rate track. This will tend to put upward pressure on longer dated paper not the reverse; and, thirdly, the ensuing slump in the NZD has investors concerned about the sustainability of the recent rate decline.

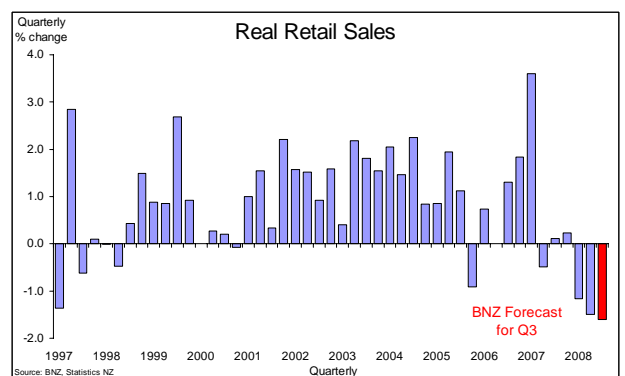
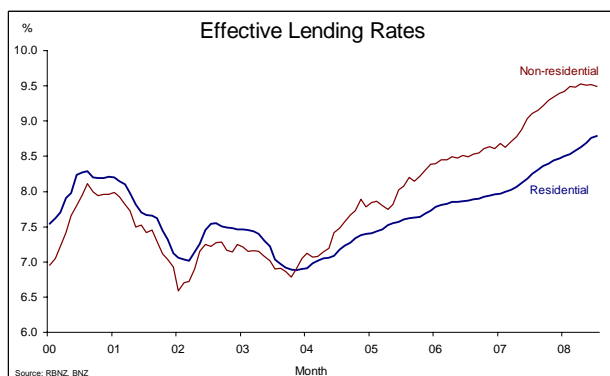
Perhaps the bigger problem though, is that Banks continue to face rising funding costs thanks to the global credit crisis. This is driving a wedge between the market base rate (the swap market) and the true cost of funding. Borrowers will not escape this.

If all this wasn't bad enough, new global banking sector regulation is requiring banks to hold capital against undrawn funds such as stand-by facilities. The costs of this, too, will eventually find their way into the system.

It is noteworthy that it's actually the business sector that is, and has been, facing the most fall out from the changing credit conditions. The graph of effective lending rates that appeared in last week's MPS shows this clearly.

Given the problems that remain then, borrowers should not yet be celebrating substantial impending reductions in their debt servicing costs. This is not to say that the Reserve Bank's actions will have no impact. To the contrary, without the latest cut, and the expectation of more to come, lending rates could have headed much higher. So, while it may not feel like it, the RBNZ has certainly delivered businesses a favour and while lending rates may not be heading down rapidly there is growing reason to believe they may have peaked.

stephen_toplis@bnz.co.nz



Contact Details

Bank of New Zealand Research



Stephen Toplis
Head of Research
+(64 4) 474 6905

Craig Ebert
Senior Markets Economist
+(64 4) 474 6799

Mark Walton
Markets Economist
+(64 4) 474 6923

Danica Hampton
Currency Strategist
+(64 4) 472 4767

Main Offices

Wellington
1 Willis Street
PO Box 2392
Wellington
New Zealand
Phone: +(64 4) 474 6145
FI: 0800 283 269
Fax: +(64 4) 474 6266

Auckland
125 Queen Street
PO Box 2139
Auckland
New Zealand
Phone: +(64 9) 976 5762
Toll Free: 0800 081 167

Christchurch
129 Hereford Street
PO Box 1461
Christchurch
New Zealand
Phone: +(64 3) 353 2219
Toll Free: 0800 854 854

NAB/nabCapital Research



Peter Jolly
Head of Research
+(61 2) 9295 1199

Alan Oster
Group Chief Economist
+(61 3) 8641 3464

Rob Henderson
Chief Economist, Markets
+(61 2) 9237 1836

John Kyriakopoulos
Currency Strategist
+(61 2) 9237 1903

Contact Phone Numbers

Wellington
Foreign Exchange +800 642 222
Fixed Income/Derivatives +800 283 269

Sydney
Foreign Exchange +800 9295 1100
Fixed Income/Derivatives +(61 2) 9295 1166

London
Foreign Exchange +800 333 00 333
Fixed Income/Derivatives +(44 20) 7796 4761

New York
Foreign Exchange +1800 125 602
Fixed Income/Derivatives +1877 377 5480

Hong Kong
Foreign Exchange +(85 2) 2526 5891
Fixed Income/Derivatives +(85 2) 2526 5891

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