BUSINESS NZ

PLANNING FORECAST

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BusinessNZ

NZ economy tainted by global uncertainty

Executive Summary

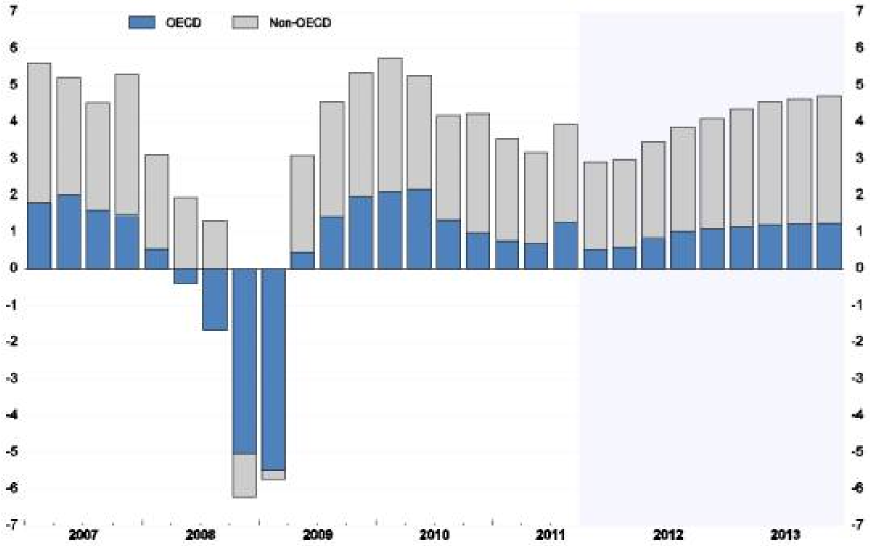
Continued global uncertainty is impacting on NZ's economic performance with a number of indicators pointing to lower growth projections than previously forecast. Clearly, significant volatility in international markets will be with us for some time as politicians and decision makers try and make progress in the face of stubborn resistance from their constituents.

However, on the positive side, NZ's key trading partners are still performing satisfactorily, boding well for steady, but not spectacular growth over the medium term.

While large parts of Europe struggle with significant sovereign debt issues, the Asia Pacific region has not been so badly affected despite some decline in growth forecasts.

A number of indicators show that non-OECD countries are providing the backbone for reasonably robust world growth projections while most OECD countries continue to languish.

Contribution to annualised quarterly world real GDP growth



Source: OECD Economic Outlook

HIGHLIGHTS

The BusinessNZ Economic Conditions Index (ECI) sits at 2 for the December 2011 quarter, up 1 from the previous quarter and down 2 on a year ago.

International markets remain volatile, underpinned by continuing high levels of sovereign debt, with stop-gap solutions having proved largely ineffective to date.

World commodity prices have continued to ease of late although New Zealand's terms of trade remain sound with continuing growth amongst our major trading partners.

Business and consumer confidence have eased but remain in positive territory, as respondents increasingly understand international uncertainty will be a fact of life for the foreseeable future.

Households and businesses are responding to future uncertainty by continuing to reduce debt burdens with wallets tucked firmly away. Investment intentions remain subdued.

Reduced capacity pressures, both internationally and domestically, continue to take the heat off inflationary pressures, although non-tradable inflation remains a concern.

According to the OECD's latest Economic Outlook (November 2011), the euro area sovereign debt crisis remains the key risk to the world economy which, unless addressed reasonably rapidly, could spread to countries thought to have relatively solid public finances.

The outlook forecast GDP across the OECD countries shows growth slowing from 1.9% this year to 1.6% in 2012, before recovering to 2.3% in 2013. Unemployment will remain stubbornly high at around 8%.

On the other hand, many non-OECD countries will see growth rates continuing at levels only dreamed of in Western economies. China's economic growth is expected to "ease" to 8.5% in 2012, from 9.3% this year before climbing back to 9.5% in 2013. After significant pressures on inflation over recent times, an easing in international commodity prices should see inflationary pressures reduce somewhat potentially allowing for a further easing in monetary policy.

On the domestic front, many indicators point to the economy going sideways after business and consumer confidence surveys earlier predicted a much needed boost to economic activity.

While the agricultural sector continues to show relatively strong growth, assisted by continued high demand for protein and a largely favourable spring in terms of grass growth, the manufacturing and services sector remain in the doldrums as reflected in the latest BNZ – BusinessNZ Performance of Manufacturing (PMI) and Performance of Services (PSI) indexes.

Clearly waning inflationary pressures should see interest rates stay relatively low for an extended period. However, it is difficult under current scenarios to see either significant growth in employment over the near term or Government "balancing the books" by 2015 as proposed.

Ignoring one-off blips in activity associated with the recent Rugby World Cup, households continue to pay down debt and wallets remain firmly tucked away while significant issues associated with the rebuild of Christchurch may see activity increase more slowly than earlier predicted. All these matters suggest steady but not strong growth over the next few quarters.

On the government front, the re-election of a National-led Government was not unexpected and coalition deals with support parties have been agreed.

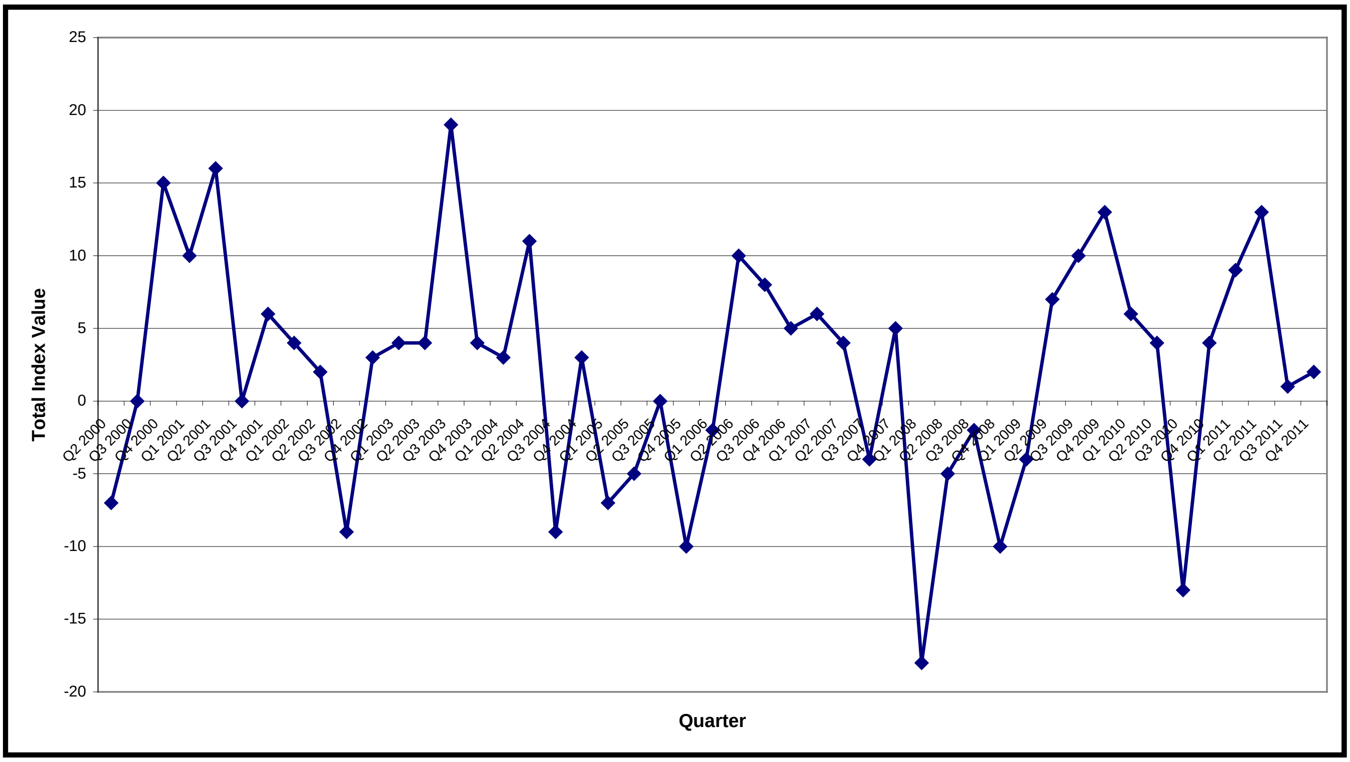
Although the Government has a political mandate to proceed in a number of areas with support from its coalition partners, it is disappointing that a key building block of a competitive economy has been allowed to fall off the back of the truck as it were. The somewhat insubstantial agreement between National and ACT to enact a Regulatory Standards Bill gives the impression that to all intents and purposes the Bill is dead and buried. This is extremely unfortunate given that improving the quality of regulation is fundamental to improving long-term competitiveness in the same way as transparent and sound monetary and fiscal policies. Hopefully, if the business community continues to promote its merits, the Government will have a change of heart and implement the Regulatory Standards Bill, strong opposition from vested interests notwithstanding.

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 2 for the December 2011 quarter, up 1 from the previous quarter and down 2 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 4 for the December 2011 quarter, up 4 on the last quarter but down 2 on a year ago. Despite an easing in international commodity prices of late, NZ still has relatively strong terms of trade.

[1] The ECI tracks 33 indicators on a quarterly basis. The overall index value for any particular quarter represents the net balance of the 33 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.

Monetary policy/pricing indicators sit at -1 for the December 2011 quarter, the same as the last quarter and the same as a year ago. Continued easing in inflationary pressures will see any interest rate rises delayed until well into next year or even beyond.

Business/consumer confidence indicators sit at 0 for the December 2011 quarter, down 1 on the previous quarter and down one on a year ago. Despite ongoing global uncertainty, business and consumer confidence levels are still relatively steady.

Labour market indicators sit at -1 for the December 2011 quarter, down 2 on the previous quarter and up 1 on a year ago. Recent official data show little change in both employment and unemployment rates and send mixed messages on future trends.

Part 2: The New Zealand economy – where are we going?

1.1. Economic growth (GDP) – outlook still positive despite risks

Domestic and world economic growth rates have been revised in light of continuing concerns about sovereign debt in the euro area and beyond. The potential for a fall-out from New Zealand's projected growth rate is very real, although this country has a number of advantages which have largely insulated New Zealand from the worst effects of the global debt crisis. Some of these will be expanded upon below.

Treasury, the Reserve Bank, and a number of forecasting agencies have cut their economic growth projections for 2012 and 2013 in light of both international and domestic events. Nevertheless, New Zealand can still look forward to growth of around 3% for 2012 and 2013, as outlined in the forecasts below.

Forecasts: Real GDP % Growth

	Years Ending		
	Dec 11	Dec 12	Dec 13
Highest	2.2	3.7	3.5
Average	2.1	3.0	3.3
Lowest	2.0	2.7	3.0

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

Despite downward revisions in growth forecasts, New Zealand can continue to feel relatively confident about the future, taking into account the very uncertain times in which we currently live.

International commodity prices, while taking a breather of late, remain at elevated levels by recent historical standards. New Zealand's trade balance is positive with continued strong demand from China, while currently, the relatively favourable exchange rate with Australia is encouraging exports into that market. Although the outlook for much of Europe is bleak, growth in the Asia-Pacific region continues to be reasonably robust, boding well for a largely export commodity dependent economy such as New Zealand.

The ANZ Commodity Price Index stands at 284.6, down 9% on the peak of 312.1 in May 2011 but still very healthy by historical standards. When converted into NZ dollars, with the impact of exchange rates taken into account, the index at present stands at 201.5, down 10% on the peak of 225.6 in March 2011 but a healthy 6% up on a year ago.

ANZ Commodity Price Index

	World Price Index	NZ$ Index
Nov 2007	246.0	184.7
Nov 2008	201.9	195.0
Nov 2009	237.7	179.4
Nov 2010	268.9	189.7
Nov 2011	284.6	201.5

Source: ANZ

Given a continuing demand for protein in the rapidly growing Asia-Pacific region, New Zealand's trade relationships with key players, including China, promise satisfactory export returns for the foreseeable future.

Domestically, the recent election of a National-led Government with various support agreements from ACT, United Future and the Maori Party, will see a relatively stable policy platform for the next three years at least. This should provide markets and investors with a degree of certainty as to the nature of intended reforms. Markets hate uncertainty and so will generally see the election of a stable government in a positive light.

The continued rebuild of Christchurch will mean significant investment in the local economy although to date, problems encountered have stalled progress in much-needed redevelopment. The question of insurance has been raised, with some finding it difficult to obtain insurance at reasonable cost.

Insurance companies need to get a return on their investment and clearly understand the risks in particular markets, but unquantifiable and unknown risks (such as the potential for further earthquakes) severely jeopardise their ability to determine the risk profile. Those that would call for Government involvement in insurance underwriting seem not to understand that this will not eliminate risk but simply transfer it from insurance companies and individual beneficiaries to taxpayers as a whole.

While New Zealand is still exposed to relatively high levels of international debt (largely private sector debt), overall debt levels, including government debt levels, are still relatively low compared with many other countries. It is crucial for the Government to ensure debt levels are controlled and reduced over time thus minimising the risk of further credit rating downgrades since obviously, these have significant implications for the country's ability to borrow internationally, and at reasonable rates.

While the Government appears reasonably confident of its ability to return to surplus by 2015, the serious need to address major expenditure items will be ongoing and cannot be avoided. Given the confidence and supply agreement with ACT, it is possible that some traditionally taboo subjects for the National Government such as increasing the age of eligibility for NZ Superannuation can at least be canvassed under those agreements, with more rigour placed on Government expenditure as a result of the agreement with ACT to introduce legislated spending limits within the next two years.

1.2 Monetary Conditions – pressures continue to ease

Interest rates – rises off the table

The Reserve Bank has left the Official Cash Rate (OCR) unchanged at 2.5 percent in its latest Monetary Policy Statement (8 December 2011).

Reserve Bank Governor Alan Bollard said: *"As foreshadowed in the September Statement, global conditions have deteriorated. Continuing difficulties related to sovereign and bank debt in a growing number of European economies have resulted in high levels of volatility in financial markets. There has also been a softening in international economic activity, including in the Asia-Pacific region.*

"Global developments are having some negative impact on New Zealand, though to date it has been limited. Business confidence has declined and investment spending is likely to remain weak for some time. In addition, tightness in international markets means funding costs for New Zealand banks will increase to some degree over the coming year."

The 90-day bill rate is forecast to increase slowly and reach 4.5% by December 2013 as evidenced in the forecasts below, while any increase in the OCR is a long way off for a number of reasons.

First and foremost, international uncertainty, reflected in reduced capital liquidity and higher interest rates, means investors are very wary of borrowing, even if they can access funds.

Second, a slow down in world growth prospects is taking some of the pressure off resources. Any further easing in commodity prices will take further pressures off imported oil and domestic food prices.

Third, a net outflow of permanent and long-term migration will ease pressure on housing in some areas.

Fourth, labour market expectations are for relatively slow employment growth and small reductions in unemployment, leaving underutilised capacity in the labour market before any generalised wage pressures eventuate.

Fifth, households, and to a certain extent, businesses, are fixated on reducing significant debt burdens with wallets tucked firmly away. Investment intentions remain relatively benign.

On the other hand, there are some potential upward pressures on monetary policy.

Any weakening in the NZ dollar as a result of further global uncertainty could import inflationary pressures, although there is no evidence of this to date.

Second, with huge resources needing to be pumped into Christchurch, the potential for major skill shortages and capacity constraints could put significant upward pressure on wage rates in the local economy.

Third, if the global crisis extends well beyond Europe, the amount of available capital could be constrained, forcing up the cost to those countries dependent on raising capital in international markets such as NZ.

On balance, the risk of interest rate rises is at present likely to be on the downside, although this could change suddenly given the violence of international markets.

Forecasts: Interest Rates (90 day bills)

	As at end of		
	Dec 11	Dec 12	Dec 13
Highest	2.8	4.0	4.7
Average	2.7	3.5	4.5
Lowest	2.5	3.1	4.2

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

The New Zealand dollar – little change but short term volatility will continue

Forecasts below show the NZ dollar, on a trade-weighted-Index (TWI) basis, as expected to stay relatively constant out to December 2013 although potentially likely to fluctuate significantly against the US dollar.

Exchange rate forecasts are fraught with difficulty, particularly short-medium term forecasts where international pressures continue to have quite dramatic short-term impacts on the value of the NZ dollar and other commodity based currencies. Given this volatility, it is important for businesses to seek professional advice on such matters as hedging or any other options available to meet their unique requirements. There is certainly no one size fits all approach.

Forecasts: Exchange Rates

	AUD (cents)		
	Dec 11	Dec 12	Dec 13
Highest	0.81	0.84	0.83
Average	0.79	0.80	0.82
Lowest	0.77	0.77	0.80

	USD (cents)		
	Dec 11	Dec 12	Dec 13
Highest	0.83	0.89	0.90
Average	0.795	0.838	0.80
Lowest	0.76	0.78	0.76

	TWI		
	Dec 11	Dec 12	Dec 13
Highest	73.3	74.8	75.4
Average	70.3	73.0	71.5
Lowest	68.0	70.6	69.5

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

Inflation - pressures subsiding

Forecasts outlined below show inflation as likely to be well within the Reserve Bank's target of 1-3% for the year to December 2011, although the limit is under pressure in the year to December 2013 where inflation is forecast to reach 2.9 percent.

Several factors are putting downward pressure on inflation. In addition to those factors outlined above which will put downward pressure on interest rates, so too will the Government’s desire to improve public sector efficiency. Improving public sector efficiency should see further labour shedding and general efficiency gains as the Government exerts itself to rein in real expenditure increases in an attempt to balance its book by 2015 – not an easy task, given the number of “no go” areas which the Government has said it is unwilling to tackle.

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Dec 11	Dec 12	Dec 13
Highest	2.7	2.6	3.2
Average	2.5	2.3	2.9
Lowest	2.4	2.1	2.7

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

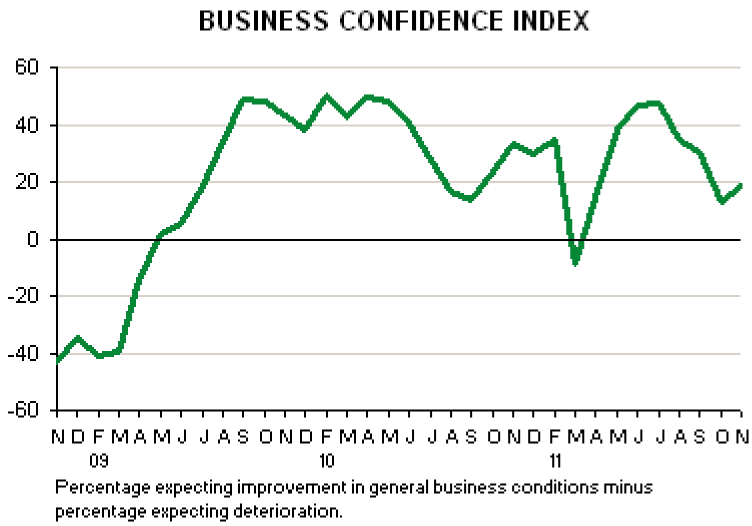
1.3 Business and consumer confidence – consolidating at lower levels

Business confidence – stoic in light of global risks

A number of surveys show business confidence, while generally drifting lower, still demonstrating real resilience in spite of ongoing global concerns and remaining in positive territory.

The National Bank's Business Outlook (November 2011) shows a net 18% of businesses expecting better times for the economy over the coming year, up 5 points on the previous month. However, of much more importance, businesses' own activity expectations are showing resilience. A net 29% of businesses expect better times ahead for their own business, marginally up (3 points) on the previous month. This is very close to the historical average.

National Bank Business Confidence Index



But despite relatively benign result for the latest month, there were also some mixed messages.

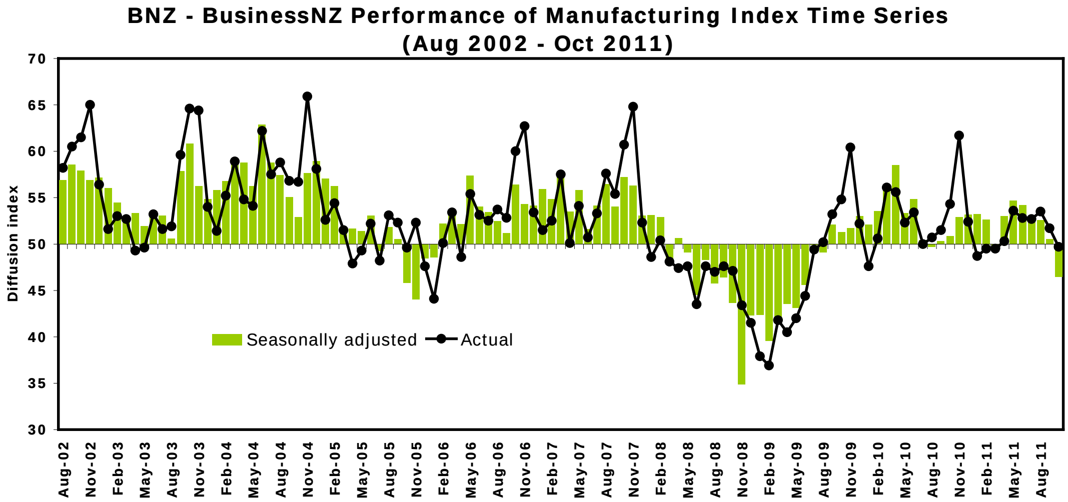
Profit expectations and investment intentions lifted slightly but on the other side of the coin, employment and export intention eased.

Perhaps not surprisingly, pricing intentions have declined marginally (down 1) while year ahead inflation expectations remain unchanged at 3.1%.

The difficultly with current business and consumer confidence surveys is that the numerous factors impacting on confidence on a monthly basis make predictions of future economic growth highly suspect. From recent surveys of business confidence the best than can be gauged is that businesses appear now to be more immune to ongoing shocks and are planning ahead with future shocks in mind – probably reflected in the yo-yo effects of employment and investment intentions. Other surveys tend to suggest that business confidence is down but certainly not out.

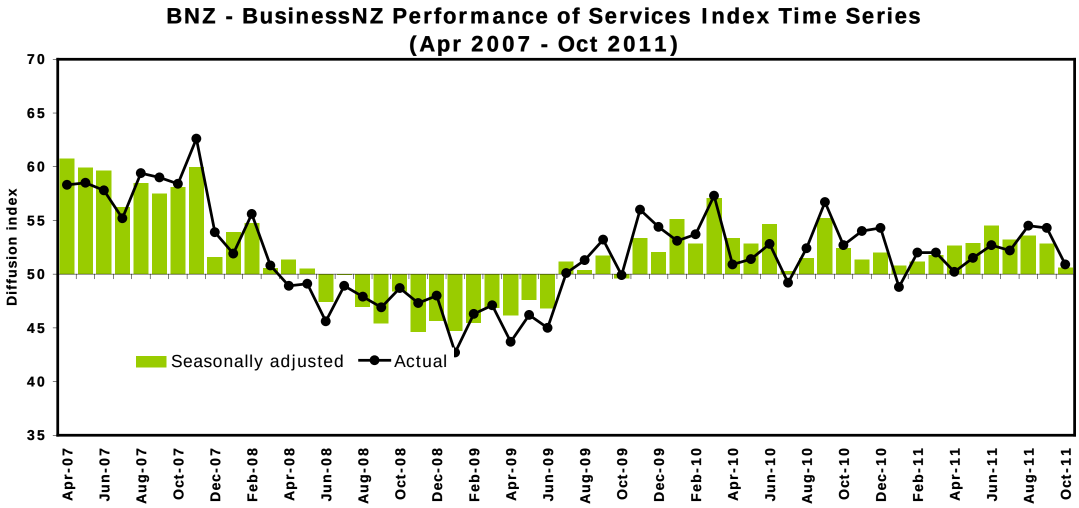
The latest BNZ-BusinessNZ Performance of Manufacturing Index (PMI) shows manufacturing activity still in the doldrums with no clear indication of expansion or contraction, although the negative result for October was something of a surprise. Was it a one-off, perhaps influenced by Rugby World Cup planning or was it a clear case of contraction consequent upon world events? At this stage the former seems likely but the next PMI result should shed more light on this issue and will be keenly anticipated for that reason.

For the record, the PMI (seasonally-adjusted) for the month of October 2011 was 46.5. A PMI reading above 50 points indicates manufacturing activity is expanding; below 50 indicates it is contracting. All five seasonally adjusted indices which make up the overall PMI were in decline during October with *finished stocks* (45.2) recording the lowest result. *Employment* (48.6) was the least affected by the decline, followed by *new orders* (47.7) and *production* (46.4). *Deliveries* (46.1) experienced its second consecutive decline in activity.



Source: BusinessNZ

The seasonally adjusted BNZ-BusinessNZ Performance of Services Index (PSI) for October 2011 (50.6) also took a breather and was down 2.3 points from September and the lowest levels of activity since July 2010.



Source: BusinessNZ

Despite the drop in overall expansion, four of the five sub-indices remained in expansion during October, although only just. *Employment* (49.5) fell into contraction after an upwards jump in September.

The agricultural sector has stayed reasonably confident despite recent reductions in international commodity prices.

Reasonably favourable spring growth conditions and continuing world demand for protein have resulted in most agricultural commodities retaining their strength with improved returns forecast to producers.

Fonterra's latest GlobalDairyTrade auction shows the price of milk powder rising 2.6%, following on from an equal gain at the previous auction two weeks ago. All seven products on offer showed gains.

Not unexpectedly, farmers are still very much focused on debt reduction but the service sector and wider economy should benefit once farmers start opening their wallets again.

Consumer confidence – stable

Consumer confidence, like business confidence, has stabilised, but at lower levels.

High levels of household debt remain a concern despite moves over recent times to cap debt expansion. On the other hand, an expanded period of low interest rates will allow households to clearly knock the top off their debt burdens.

While some prices of day-to-day essential goods have stabilised of late (e.g. food, fruit and fuel), other prices continue to rise, particularly insurance costs in light of the Christchurch earthquake and other similar natural catastrophes around the world. This will put added pressure on household budgets.

The outlook for employment growth and unemployment is largely static with a number of surveys showing very mild employment growth forecast over the medium term. With significant uncertainty remaining in international markets, businesses are clearly nervous about taking on new employees in case demand should reduce.

Consumers' cautious approach to expenditure is evidenced by the relatively slow growth in electronic and retail sales' data with retailers continuing to discount heavily in order to move stock. Long-term interest-free credit has become a significant part of retailers' strategy in some sub-sectors.

1.4 Labour market – slow growth

Employment – mixed outlook

Both official and forward-looking survey data point to relatively slow employment growth and unemployment easing slightly over the medium term, as outlined in the forecasts below.

Household Labour Force Survey: June 2011 quarter

Seasonally adjusted	September 2011 quarter	Quarterly change	Annual change
Unemployment rate	6.6%	+0.1	+0.2
Unemployed	157,000	+1.7%	+4.6%
Employed	2,218,000	+0.2%	+1.1%
Not in the labour force	1,095,000	-0.2%	+0.5%
Employment rate	63.9%	0.0	0.0
Labour force participation rate	68.4%	+0.1	+0.1

Source: Statistics NZ

After very strong growth in employment and associated reductions in unemployment in the first quarter of 2011, both employment and unemployment numbers remained relatively static for both the June and September quarters as measured by Statistics NZ's Household Labour Force Survey (HLFS). The unemployment rate was up marginally in the September quarter at 6.6, while employment growth also showed a slight increase (up 5,000) on the previous quarter.

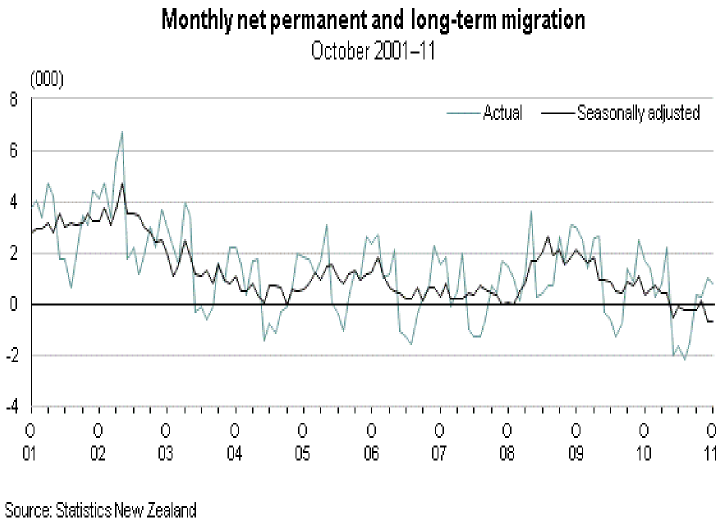
The latest results showing a relatively static picture of employment growth and levels of unemployment are largely in line with a number of other business opinion surveys and the ANZ Job Adds series. The ANZ Jobs Adds series points to relatively slow employment growth (with reductions in both the months of September and October) while the Westpac McDermott Miller Employment Confidence Index dropped slightly in the September quarter to 104.2, down from 106.1 in the June quarter. The BNZ – BusinessNZ PMI and PSI also showed significant employment declines in October.

There is a question whether the Rugby World Cup (September/October) impacted on some of these figures or whether they reflect the fact that businesses are adopting a wait and see attitude before taking on new staff. If anything, recent global events are likely to heighten risk, suggesting the labour market is likely to go sideways for some time to come.

A significant issue which policy makers need to tackle is the impact of youth unemployment. According to the HLFS, over one quarter of youths is officially unemployed.

While there are a number of legitimate reasons for the youth unemployment rate to be higher than average, including a general lack of strong attachment to the labour market since many young people may have alternative sources of income (e.g. parents) or don't have dependents to support, gaining initial attachment to the labour market is an important discipline helping to improve individual productivity and hence earning potential over time. In this respect, moves by the Government to establish a new "starting-out" wage for those aged 16 to 19 who meet certain criteria is a useful step towards helping address the unacceptable rate of youth unemployment.

Two interesting factors which could significantly affect labour market outcomes over the medium term are the impact of the Christchurch rebuild and the potential impact on the size of the labour force given net migration outflows of late. By all accounts the Christchurch rebuild is going slower than expected for a number of reasons, but is expected to crank up next year.



In respect to net permanent and long-term migration, net outflows could well impact on the potential size of the labour force pool and more importantly, on the skill levels that remain. Often net migration flows are a good leading indicator of future economic growth prospects and the latest result do not augur well for future growth prospects.

Forecasts: Unemployment % (HLFS)

	Quarter		
	Dec 11	Dec 12	Dec 13
Highest	6.5	5.9	5.8
Average	6.4	5.6	5.1
Lowest	6.3	5.3	4.7

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

Labour costs – subdued

Forecasts below indicate that labour costs are expected to increase modestly to around 2.5% for the years ending December 2012 and 2013. This is very much in line with the long-run average for the LCI and up slightly on recent annual increases which have averaged around 2%. The forecasts largely reflect the slight pick up in labour market outcomes which most forward looking surveys predict.

While there will undoubtedly be some upward wage pressures in particular sectors (e.g. in the trades sector and associated services involved with the Christchurch rebuild), overall wage pressures currently appear to be modest.

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

	Years ending		
	Dec 11	Dec 12	Dec 13
Highest	2.1	3.0	3.1
Average	2.0	2.4	2.6
Lowest	1.9	2.0	2.2

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