BUSINESS NZ

PLANNING FORECAST

DECEMBER 2013

BusinessNZ

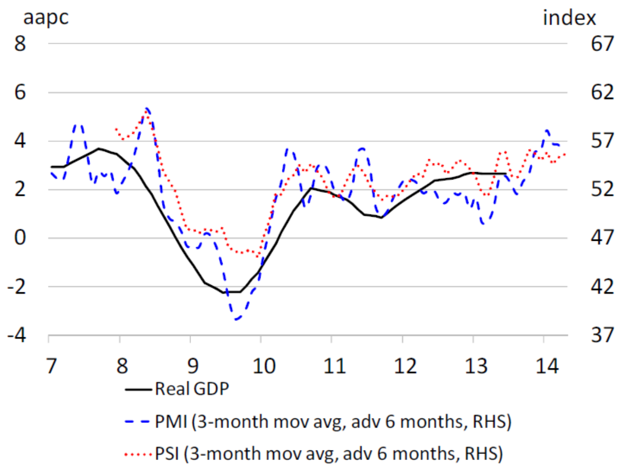
NZ Economy – wave of optimism

Executive Summary

After numerous false starts the NZ economy is now really beginning to bloom.

Key forward looking indicators such as business and consumer confidence remain at heightened levels and while it is accepted that confidence indicators can at times be fickle, currently, the indicators are supported by hard data. For example, the BNZ - BusinessNZ Performance of Manufacturing Index (PMI) and the Performance of Services Index (PSI) are showing business as consistently strong.

Most reputable commentators broadly accept that both the PMI and PSI are reasonably good indicators of the direction of GDP growth and this can be seen below where real GDP is tracked against both the PMI and PSI.



Source: Statistics NZ, BusinessNZ, Treasury

The growth story is not confined to manufacturing and services though. In fact the key contributor continues to be the agricultural sector which, despite the drought earlier this year, goes from strength to strength as reflected in NZ's best terms of trade since 1973.

Simply put, terms of trade are a measure of the purchasing power of New Zealand's exports abroad and mean that, increasingly, for the same amount of exports the country can buy more imports.

In the September quarter, dairy export prices rose 24% to their highest level since 2008 and are now 46% higher than a year ago. Some of this increase will be due to restricted supply as a result of the drought last summer, although very good growing conditions over spring should make for a bumper 2013/14 season. Fonterra's decision to increase the projected milk payout to an historical high is just another part of the positive jigsaw for agriculture.

Construction activity continues to crank up while consumer confidence has seen consumers opening their wallets with higher levels of electronic, and retail sales generally, being recorded on the back of a much stronger labour market outlook.

According to the latest Organisation for Economic Cooperation (OECD) *Economic Outlook,* New Zealand is one of the fastest growing economies in the developed world with 3.3% growth forecast for 2014, compared with an OECD average of 2.3%.

HIGHLIGHTS

The BusinessNZ Economic Conditions Index (ECI) sits at 14 for the December 2013 quarter, up 9 on the previous quarter and up 7 on a year ago.

Business and consumer confidence remain at elevated levels with improved growth prospects increasingly evident over a number of sectors.

At long last, the labour market is improving with a number of forward-looking indicators pointing to relatively strong employment growth and a consequent reduction in unemployment.

The latest Organisation for Economic Cooperation (OECD) *Economic Outlook* places New Zealand as one of the fastest growing economies in the developed world. The OECD has forecast 3.3% growth for the NZ economy in 2014, compared with a growth average for OECD countries of 2.3%.

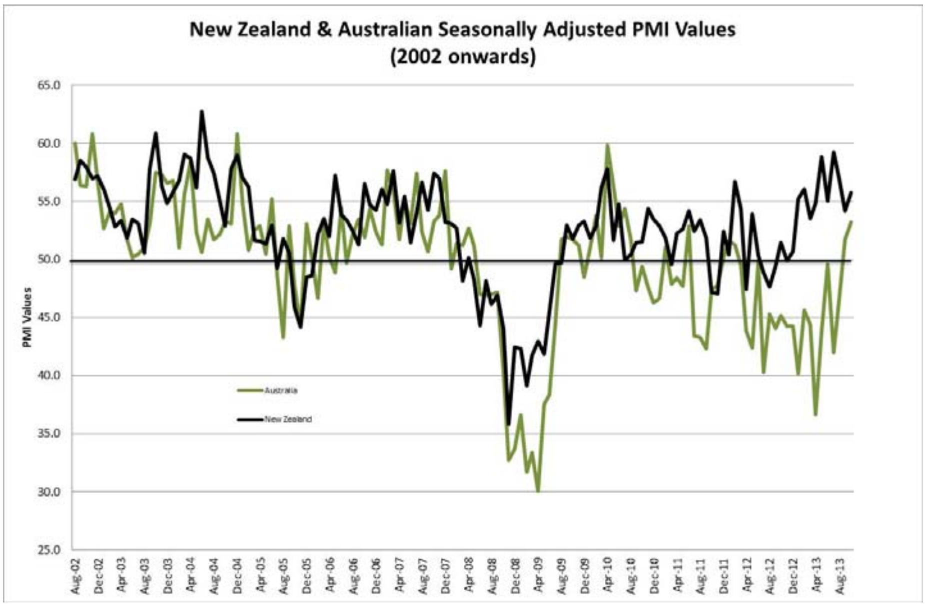
While the world economy is still fragile, with a number of developed countries facing major debt pressures, NZ's major trading partners, including China, are still performing credibly, with a growth rate forecast at around 7.5% per annum. Australia's economic data is also improving.

Notwithstanding a very positive outlook, increasing inflationary pressures are beginning to be felt placing greater pressure on resources and assisted in part by a significant rise in net inward migration.

High levels of debt continue to be a concern with farm debt levels exceeding $50 billion and household debt levels again on the rise after earlier attempts to rein in debt post the GFC.

The international economy is improving slowly with continued positive news coming out of China (NZ's exports to China are up a staggering 38.5% over the past 12 months). And the US economy is slowly improving its performance despite concerns over debt levels and the on again, off again saga of monetary policy settings.

After facing significant headwinds earlier this year, the Australian economy is also showing some signs of improvement as evidenced by increased capital expenditure, although residential activity remains flat. The Australian PMI has improved significantly from a disastrous situation earlier this year but while now back in positive territory, still trails NZ's PMI (see below). The Australian PSI has also improved of late though still in slightly negative territory and again lagging behind the NZ PSI.



Notwithstanding all the positives above, there are risks domestically.

The potential for inflation to rear its head should not be downplayed in light of strong housing demand currently pushing up prices, particularly in Auckland and Christchurch. The impact of the Reserve Bank's decision to introduce loan-to-value-ratios on actual house prices (as opposed to the types of loans being issued) is still debatable. Rapidly rising net migration inflows will place added pressures on an already stretched market.

Resource demand pressures will lead to generalised inflationary pressures, including modest wage rises as unemployment continues to trend downwards.

Significant (and rising) levels of farm debt are a concern, with overall agricultural sector debt now exceeding $50 billion – of which two-thirds is focused on the dairy sector.

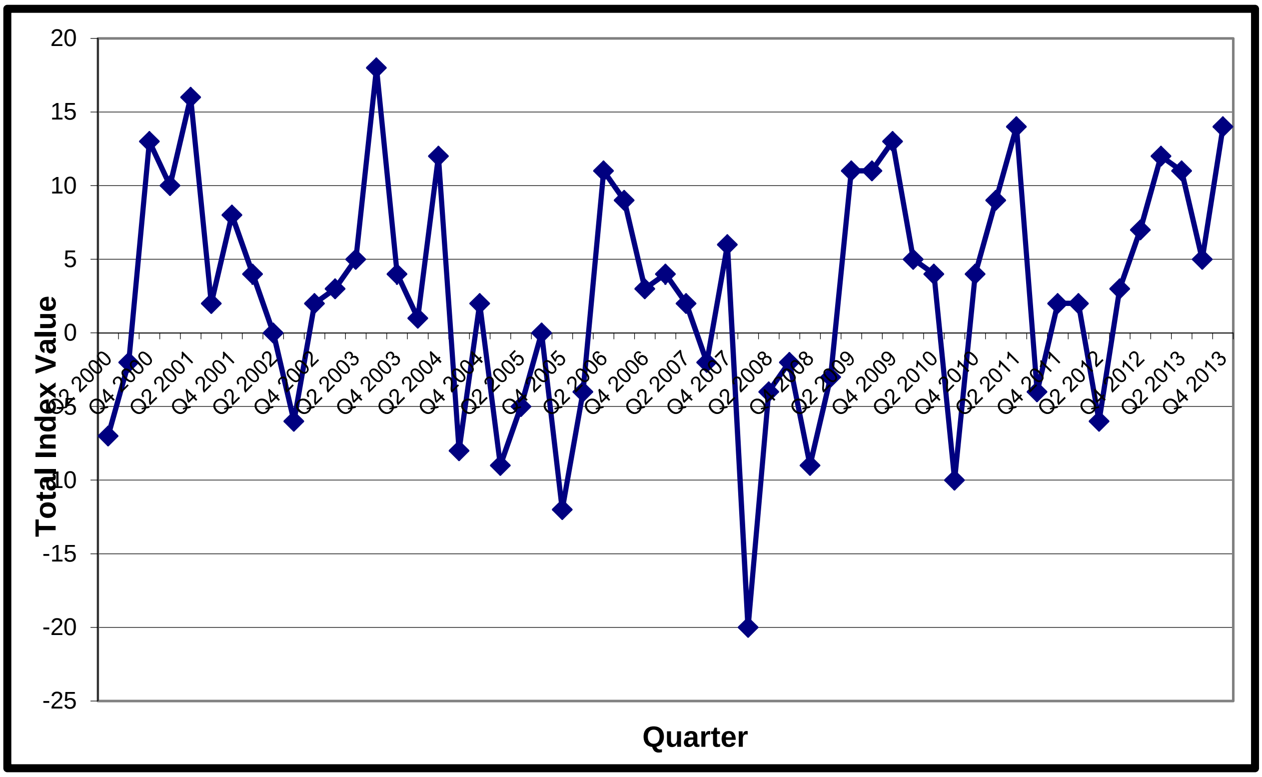
Similarly, household debt levels are also on the rise and may come back to haunt some individuals as debt servicing costs increase in light of projected interest rate rises. After reducing debt to more manageable levels post the GFC, the brake has now to some extent been let off.

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 14 for the December 2013 quarter, up 9 on the previous quarter and an improvement of 7 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 2013 quarter, the same as the last quarter and up 8 on a year ago. After a mid-year blip, largely as the result of the earlier drought, firm growth in commodity prices, particularly dairy prices, has resulted in the highest terms of trade in 40 years.

Monetary policy/pricing indicators sit at -2 for the December 2013 quarter, up 2 on the last quarter and down 6 on a year ago. Inflationary pressures are building on the back of the relatively strong growth in house prices, increased net inward migration, and a general increase in pressure on resources, including belatedly, labour.

[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.

<u>Business/consumer confidence indicators</u> sit at 5 for the December 2013 quarter, up 4 on the previous quarter and down 2 on a year ago. Almost without exception, both business and consumer confidence surveys show sentiment at elevated levels. Confidence is increasingly spread amongst a number of sectors, including agriculture, manufacturing, construction, and the broader services sector.

<u>Labour market indicators</u> sit at 7 for the December 2013 quarter, up 3 on the previous quarter and up 7 on a year ago. After a significant period in limbo, both official and forward-looking indicators point to relatively strong employment growth and further reductions in unemployment.

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

1.1 Economic growth (GDP) – solid

Economic growth is forecast to average around 3% per annum out to December 2015 (see below), making NZ one of the fastest growing developed economies.

The latest Organisation for Economic Cooperation (OECD) *Economic Outlook* places New Zealand as one of the fastest growing economies in the developed world. The OECD has forecast the NZ economy to rise to 3.3% in 2014, compared with an average growth of 2.3% for OECD countries.

While GDP growth took a knock in the middle of this year largely as a result of the earlier drought, projections are for a significantly improved outcome for the December quarter (when official data is released in late March 2014). Capital stock numbers were affected (adversely affecting production) but some of the drought's effects have been offset by relatively good growing conditions over much of the country in spring/early summer. However, the biggest offset has been the strong international demand which has boosted commodity prices (dairy in particular) and is reflected in NZ's best terms of trade since 1973.

Forecasts: Real GDP % Growth

	Years Ending		
	Dec 13	Dec 14	Dec 15
Highest	2.9	3.7	3.1
Average	2.8	3.4	2.6
Lowest	2.5	3.0	2.2

Source: ANZ, ASB, BNZ, and Westpac

Factors positive for the future growth of the economy are outlined below:

- **The international economy is showing signs of improving growth prospects which is good news of NZ's commodity producers**

Economic growth prospects for NZ's largest trading partner, China, are still robust (at around 7.5%) with solid demand for NZ's agriculture reflected in both trade volumes and price increases. In the past 12 months exports to China have increased a staggering 38.5% with NZ's trade relationship with China going from strength to strength. The US economy is slowly improving while much of Europe is also on the improve, despite continuing concerns about Greece and Spain.

The ANZ Commodity Price Index, in world price terms, is 21.4% ahead of a year earlier. When converted into NZ dollars, this is still a solid 20.2% increase on a year ago – partially reflected in a slightly higher NZ dollar.

ANZ Commodity Price Index

	World Price Index	Annual % Change	NZ$ Index	Annual % Change
Nov 2009	236.8	17.3	178.6	-8.4
Nov 2010	275.1	16.2	193.9	8.6
Nov 2011	288.5	4.9	203.9	5.2
Nov 2012	269.1	-6.7	178.3	-12.6
Aug 2013	326.7	21.4	214.2	20.2

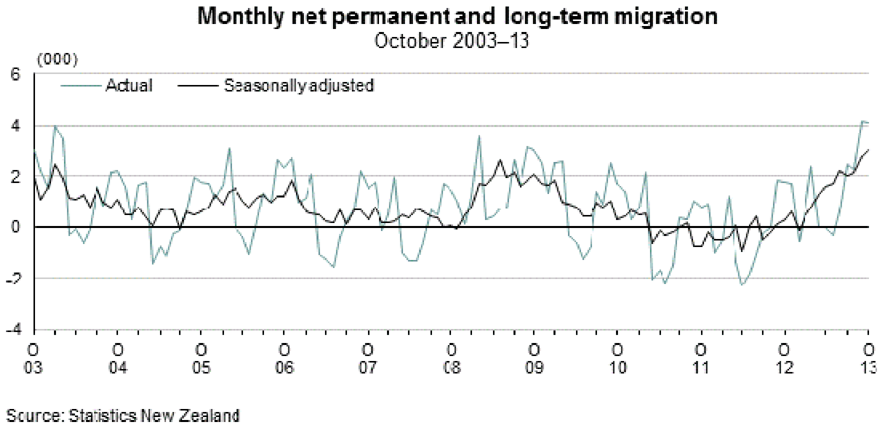
Source: The ANZ

- **The ongoing rebuild of Christchurch….the $40 billion issue**

As will be repeated for some time (possibly years), the Christchurch rebuild is leading the charge on resource use. But beyond Christchurch, greater construction activity is also forecast for Auckland, helped by moves to reduce the regulatory costs associated with housing development (e.g. government moves to tighten criteria for development contributions) and ongoing earthquake strengthening activity will soak up resources over much of the country.

- **Improving employment prospects will boast household demand**

Consumers are increasingly opening their wallets on the back of an improving housing market and an improved employment outlook. Growth in net inward migration will add to demand pressures and boost growth potential, while a reduction in accident insurance (ACC) levies for 2014/15, recently announced by the Government, will provide many households with a small lift in disposable income.



Despite all the above positives, there are potential (and existing) risks to growth.

These include:

- **The future outlook for the international economy**

As mentioned earlier, NZ's major trading partners (particularly China) are sucking up NZ's agricultural commodities with this greater demand reflected in historically high prices and the best terms of trade in 40 years This is currently a positive for NZ but the country remains dependent on its key export markets continuing to improve. And despite a somewhat improved international outlook, there are still significant risks associated with international debt and monetary policy settings which have yet to work through the system. How, for example, will the (eventual) US easing off from its monetary policy stimulus package impact on the NZ exchange rate? Will NZ's strong commodity performance drive greater international interest in the NZ dollar? This a particularly interesting question given that NZ will be raising interest rates when for most of the developed world, central bank rates are close to zero.

- **Regulatory risk**

Changing regulatory structures (whether for short-term perceived political gain or for other reasons) pose ongoing risks for investors and lead, yet again to demands for the Government (and opposition parties) to rethink their objections to a Regulatory Responsibility Act (RRA). Sound principles should provide guidance to legislators as to when and why they should or should not regulate.

In essence investors are loath to invest if there is a risk that the rules of engagement will change, either through ad hoc government decision-making or more broadly, through flawed policy-making. While it is impossible to control what happens internationally, it is important for NZ to control and influence those things that can controlled by promoting good regulatory decision-making and providing regulatory certainty to the extent that this can be achieved.

There are still significant decisions to be made about the long-term framework for natural resource allocation and use rights in respect to freshwater. Ensuring a rigorous framework which out lasts multiple governments is crucial to the efficient use of what is one of NZ most valuable natural assets.

- **Household and agricultural debt levels**

Debt levels leave households and businesses exposed to changes in international sentiment with inevitable interest rate rises making debt servicing costs more expensive should commodity prices take a dive (for whatever reason).

Significant (and rising) levels of farm debt are an issue and agricultural sector debt overall now exceeds $50 billion – two-thirds of which is focused on the dairy sector.

Similarly, household debt levels are on the rise again and may come back to haunt individuals as debt servicing costs increase in light of projected interest rate rises. After getting debt down to more manageable levels post the GFC, the brake has now to some extent been released.

There is an increasing risk of significant and relatively rapid rises in the OCR as the Reserve Bank grapples to control inflation next year and beyond.

1.2 Monetary Conditions – tightening the screws

It is a matter of when the Reserve Bank will act to crank up interest rates rather than if.

Interest rates – rising

The 90-day bill rate is forecast to increase relatively slowly to reach 3.7% by December 2014 and 4.4% by December 2015, as evidenced by the forecasts below. Meanwhile, long-term interest rates have already risen substantially so it is only a matter of time before the increases begin to flow through to the cost of fixed-rate mortgages.

Forecasts: Interest Rates (90 day bills)

	As at end of		
	Dec 13	Dec 14	Dec 15
Highest	2.8	4.0	4.7
Average	2.7	3.7	4.4
Lowest	2.7	3.5	4.2

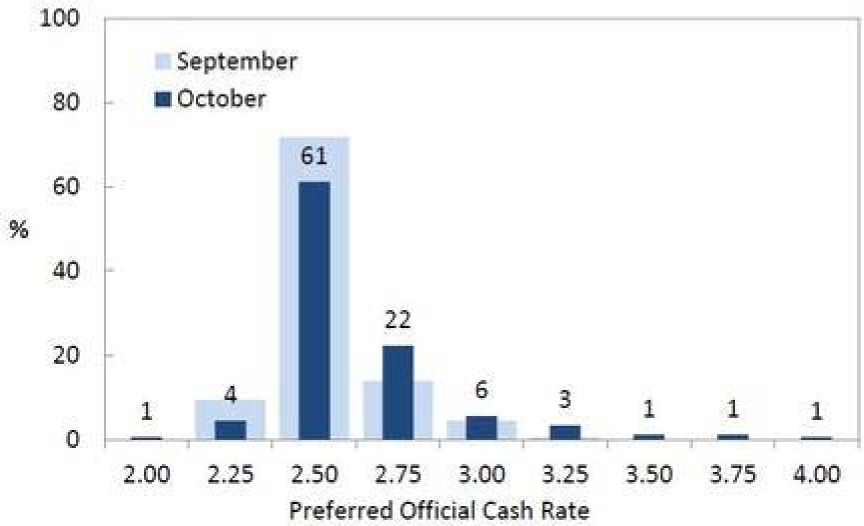
Source: ANZ, ASB, BNZ, and Westpac

The Reserve Bank has clearly signalled that interest rate rises will be inevitable next year and has more-or-less suggested that the loan-to-value-ratio measures were simply a delaying tactic – this in spite of the fact that the Bank has always insisted that the LVR initiatives were primarily to ensure ongoing financial market stability.

As mentioned earlier, the return of accumulating household debt together with expansion in some sectors, e.g. agriculture, has the potential to create instability if interest rates rise rapidly (as they may do), given the significant underlying inflationary pressures in the economy. Interest rates could rise quite fast and quite substantially over the next year or so.

Despite these risks, the New Zealand Institute of Economic Research's (NZIER) Shadow Monetary Policy Board (which has the task of recommending interest rate settings ahead of each decision by the Governor of the Reserve Bank) found that most of its members continue to support no change to the OCR.

Most of NZIER's *Shadow Board* favour leaving the OCR at 2.50%



Source: NZIER

"The economy is starting to show signs of robust growth. But inflation is low and the exchange rate remains high, weakening the outlook for New Zealand's exports. So most members recommend leaving interest rates on hold"

Nonetheless the Board's preferences are shifting, with more support than in previous months for higher interest rates. Auckland's housing market is very bubbly, risking a costly downwards correction in house prices in the future. Two Board members recommend raising rates right now to start addressing this risk"

The New Zealand dollar

Forecasts below show the NZ dollar generally remaining at elevated levels against the Aussie, but drifting lower against the US, which in part reflects an expectation that the US will taper off its quantitative easing very soon.

Forecasts: Exchange Rates

AUD (cents)			
	Dec 13	Dec 14	Dec 15
Highest	0.89	0.90	0.88
Average	0.88	0.88	0.87
Lowest	0.87	0.86	0.86

USD (cents)			
	Dec 13	Dec 14	Dec 15
Highest	0.85	0.81	0.76
Average	0.83	0.77	0.74
Lowest	0.81	0.75	0.70

TWI			
	Dec 13	Dec 14	Dec 15
Highest	78.3	76.4	73.4
Average	77.4	73.9	71.7
Lowest	75.6	70.1	70.1

Source: ANZ, ASB, BNZ, and Westpac

However, over the short-term, there is likely to be further upward pressure on the NZ dollar against our major trading partners simply because of the relatively strong projected growth and a relatively stable economic environment (comparatively speaking) as an international investment destination. NZ will be raising interest rates at a time when most developed countries have interest rates close to zero (see below). This could also put upward pressure on the NZ dollar, at least over the short term.

Major Central Banks Interest Rates

Central Banks	*Current Interest Rate*
Bank of Canada	1.000 %
Bank of England	0.500 %
Bank of Japan	0.100 %
European Central Bank	0.250 %
Federal Reserve	0.250 %
Reserve Bank of Australia	2.500 %
Reserve Bank of New Zealand	2.500 %
Swiss National Bank	0.000 %

Inflation - pressures building

Forecasts outlined below show inflation likely to rise to just over 2% by December 2014 and to 2.6% by 2015.

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Dec 13	Dec 14	Dec 15
Highest	1.5	2.2	2.8
Average	1.5	2.1	2.6
Lowest	1.3	1.9	2.4

Source: ANZ, ASB, BNZ, and Westpac

After a relatively long period of very subdued inflation, pressures are building.

Inflation risks include:

- Elevated demand for housing, particularly in Auckland, driving house prices significantly higher (despite moves to improve the supply side of the market by opening up more land for early development and Reserve Bank efforts to reduce demand through restrictions imposed on high loan-to-value-ratios.
- Relatively strong demand for NZ commodities underpinning domestic prices for staple products e.g. meat and dairy products
- Earthquake strengthening costs for buildings probably leading to increased costs for premium rental accommodation as many organisations become more selective about the buildings they are prepared to rent.
- The ongoing repricing of risk associated with the Christchurch earthquakes continuing to flow through to insurance premiums for NZ buildings across the country.
- Increased net inward migration adding to demand pressures.
- An improving labour market outlook putting increased pressure on wage rates (although salary and wage movements to date have been relatively subdued).
- The implications for imported inflation from the future direction of the NZ dollar. NZ's relatively elevated position currently takes much of the heat out of potential cost escalation but this may change should the US move soon to rein in quantitative easing.

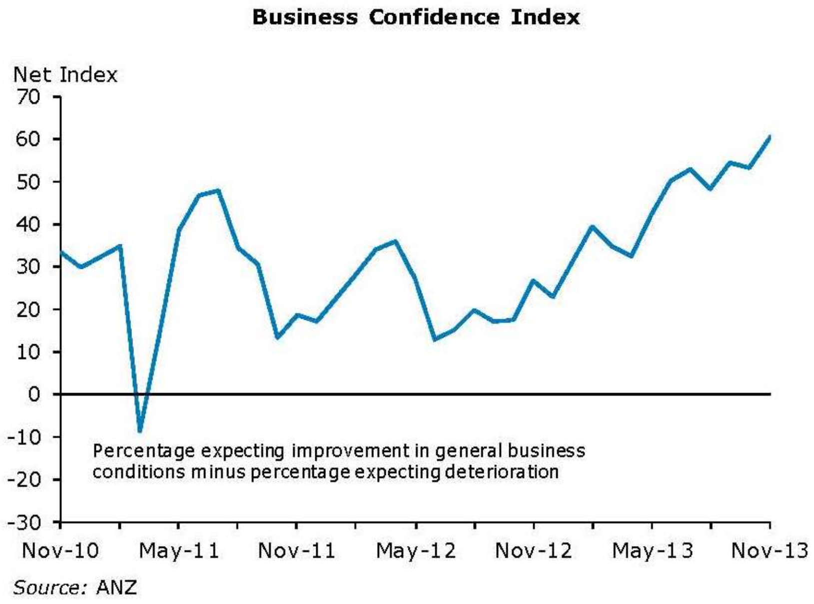
As a package, these risks are substantial, and underpin the risk of significant and relatively rapid rises in the OCR as the Reserve Bank grapples to control inflation next year and beyond. The only real issue for the Reserve Bank is when to the pull the trigger on interest rate rises. The potential implications on the exchange rate also need to be considered in this context.

1.3 Business and consumer confidence – stellar

Business confidence – riding high

Business confidence has continued to remain at elevated levels as evidenced by a number of surveys.

The ANZ Business Outlook shows that for the month of November 2013, a net 61% of respondents expected business conditions to improve over the year ahead, up 8 points on the previous month and just shy of a fifteen-year high. Perhaps more importantly, the breadth of confidence across all major sectors is extremely encouraging and bodes well for solid growth.



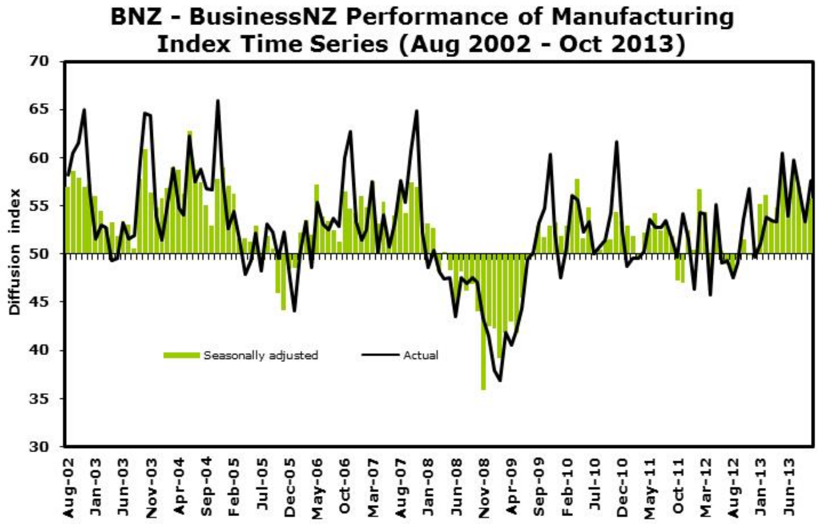
At the firm level, a net 47% expect more activity over the coming year for their own business (unchanged from the previous month) and continuing to remain at exceptionally high levels by historical standards. Key economic indicators such as expected profitability and labour hiring intentions both hit 19-year highs with, not surprisingly, construction leading the charge in respect to employment growth.

Most of the survey's key components generally remain at elevated levels although there are some pressures developing in respect to both pricing intentions and expected lifts in interest rates.

Other surveys also show the economy surging ahead, as confirmed by the continuation of strong expansion in the BNZ-BusinessNZ Performance of Manufacturing Index (PMI) over the first 10 months of 2013.

The BNZ-BusinessNZ seasonally adjusted PMI for October stood at 55.7, 1.5 points higher than in September. The sector has now been in expansion for 11 consecutive months and compared with previous October results the 2013 value was the highest since 2007. 0verall, the PMI has averaged 56.0 since the start of 2013. A PMI reading above 50 points indicates manufacturing activity expanding; below 50 indicates it is contracting.

All five seasonally adjusted main diffusion indices were in expansion for October, again led by *new orders* (60.4) which saw a return to a post-60 point value. *Production* (57.2) returned to similar levels of activity seen in August, while *deliveries of raw materials* (55.1) followed a similar pattern. *Finished stocks* (51.2) lifted up from its no change level in September and *employment* (52.1) returned to expansion after a decline in activity in the previous month.



Source: BusinessNZ

Expansion was centred more towards the top and bottom parts of New Zealand during October. In the North Island, the *Northern* region (60.7) recorded its highest level of activity since November 2010. By contrast, the *Central* region (53.6) dropped 4.9 points from September. In the South Island, the *Canterbury/Westland* region (52.5) recovered from its slip in September, while the *Otago-Southland* region (58.0) returned to levels of activity similar to those seen in August.

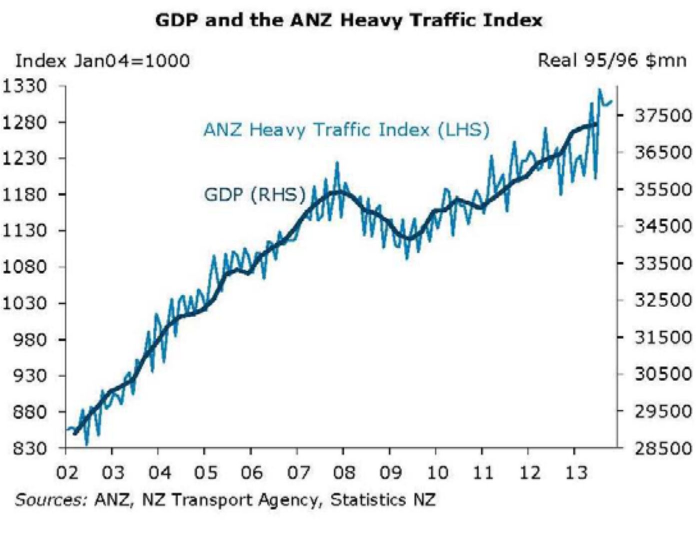
Manufacturing by industry sub-groups was at various levels of expansion during October. *Machinery & equipment manufacturing* (59.7) continued to show the strongest level of activity, with another result around the 60-point mark. *Petroleum, coal, chemical & associated product manufacturing* (57.3) improved from the previous month and *metal product manufacturing* (51.9) swung back into expansion for October.

The increased level of expansion for October also saw the proportion of positive comments for the month (63.8%) increase from September (58.1%) and August (57.5%). Globally, the JPMorgan Global Manufacturing PMI for October was 52.1, the highest level of activity for two and a half years.

The BNZ – BusinessNZ Performance of Services Index (PSI) has also continued to show strong growth through 2013 with the PSI sitting at 58.2 for October.

Other sectors also show strong growth prospects, including agriculture and construction, as mentioned earlier.

The ANZ Bank Truckometer, which measures heavy traffic movements, has generally shown solid growth of late. Historically, there has been a relatively close relationship between this index and future GDP growth (see below), so this is yet another sign of an economy where prospects continue to improve.



Consumer confidence – still growing

Consumer confidence remains firmly in positive territory.

The latest ANZ-Roy Morgan NZ Consumer Confidence survey shows consumer sentiment continuing to lift and now at its highest level since 2010.

The key ingredient – a notable improvement in labour market outcomes - will be a significant driver to ensuring that confidence remains at high levels into next year.

The one fly in the ointment is household debt levels, which despite strong projected growth in the economy, remain elevated and may dent consumer confidence when interest rate rises start to bite next year and beyond.

1.4 Labour market – positive outcomes ahead

Employment – on the rise

Employment growth is on the rise with associated reductions in unemployment forecast, as outlined below. The unemployment rate is expected to reach 5.1% by December 2015 (see below).

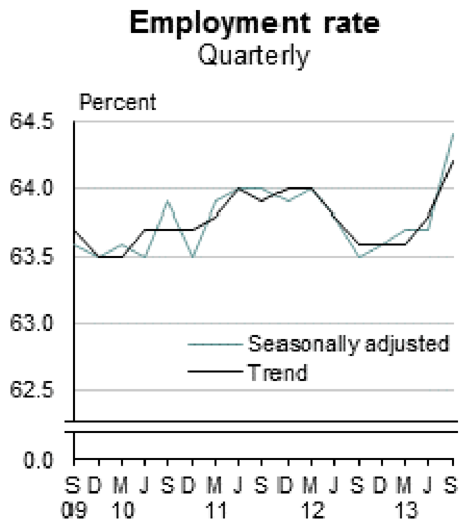
Forecasts: Unemployment % (HLFS)

	Quarter		
	Dec 13	Dec 14	Dec 15
Highest	6.1	5.8	5.3
Average	6.0	5.5	5.1
Lowest	5.9	5.1	4.8

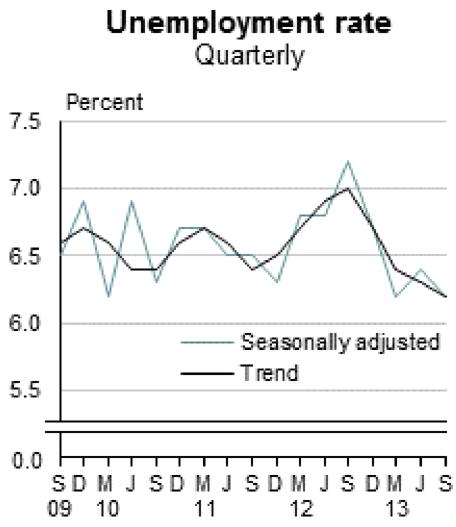
Source: ANZ, ASB, BNZ, and Westpac

The Household Labour Force Survey (HLFS) results for the September quarter 2013 show the underlying strength of the recovery in employment.

The number of employed increased by 27,000 compared with the June 2013 quarter while the unemployment rate fell 0.2 percentage points to 6.2%.



Source: Statistics New Zealand



Source: Statistics New Zealand

While BusinessNZ has been concerned about the apparent yo-yo effects of the HLFS over previous quarters, there is now clear evidence from forward-looking indicators that labour market activity is heating up - good news in terms of encouraging more people into productive employment and of providing opportunities to boost income levels.

Both the BusinessNZ – Bank of NZ PMI and PSI show employment outcomes as improving both in the manufacturing and services sectors. Other surveys of business confidence show strong employment growth prospects, particularly in the construction sector. Relatively strong growth in net inward migration will also boost demand for goods and services and hence employment opportunities.

The BNZ-BusinessNZ PMI employment sub-index sat at 52.1 for the month of October. Meanwhile the PSI sat at 52.8.

The ANZ NZ Jobs Ads series shows job advertising rose 4.5% in October (seasonally-adjusted) on top of a 1.3% lift in September. The index is 9.75% higher than a year ago but regional numbers are still relatively volatile. Given that labour market outcomes generally lag behind improved economic performance, the rise in job ads over recent months bodes well for future economic and employment growth.

Labour costs – slowly rising

Forecasts below indicate that labour costs are expected to increase only slowly to around 2.3% for the year ending September 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 1.7%. Forecasts largely reflect the pick-up expected in labour market outcomes predicted over the medium term.

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

	Years ending		
	Dec 13	Dec 14	Dec 15
Highest	1.8	2.7	2.5
Average	1.7	2.2	2.3
Lowest	1.6	1.9	2.1

Source: ANZ, ASB, BNZ, and Westpac

Private sector salary and wage rates (including overtime) increased 1.6% in the year to the September 2013 quarter. Public sector salary and wage rates (including overtime) also increased 1.6% per cent in the year to the September 2013 quarter.

There will likely be some upward wage pressure over the coming year as labour resources become increasingly constrained.