BUSINESS NZ

PLANNING FORECAST

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BusinessNZ

NZ Economy – Shuffling forward

Executive Summary

Official and unofficial data show the NZ economy is growing slowly. On one hand, given ongoing uncertainty in the global economic outlook, this could be considered positive. On the other hand, the NZ economy faces some potential risks in meeting a number of the economic forecasts outlined in the recent budget.

International commodity prices have tanked and continue to drop faster than expected. This is reflected in reduced projections for dairy payouts and has already significantly dented confidence in the rural sector as evidenced by surveys of rural confidence.

The business sector in general continues to take a wait and see attitude to new investment as reflected in little net employment growth, while households continue to have their wallets firmly tucked away.

But the situation is not all bad. A focus on debt reduction by businesses and households is important given NZ's vulnerability to changes in international investor sentiment. Interest rates remain at historic lows, assisting with debt reduction, while inflationary pressures remain firmly in check.

Moreover, NZ is in a much better position than many of the countries to which we traditionally compare ourselves, reflecting in no small part a transparent policy process. This has avoided some of the more negative outcomes consequent upon the large expansionary regulatory and fiscal policies many developed countries have adopted.

Talking of policy, the theme of the Budget 2012 was *'Investing in Our Future'* and put some flesh on the bones of the Government's four priority areas outlined in the budget Policy Statement earlier this year:

(a) Responsibly managing the Government's finances;
(b) Building a more productive and competitive economy;
(c) Delivering better public services within tight financial constraints; and
(d) Rebuilding Christchurch.

Budget 2012 generally lived up to expectations, with most initiatives already pre-announced in the weeks and days leading up to the Budget event itself. This is some ways represents much more mature thinking in respect to the Budget process itself, in that the days of 'big bang' announcements (often with little thought as to the unintended consequences) are largely over.

This Government is being extremely careful to try and take the public with it through the reform process (e.g. in respect to mild social welfare and health changes) but the danger with a gradualist approach is that the world will move on before substantial reforms can be implemented. Therefore the Government is always in danger of being in catch-up mode.

HIGHLIGHTS

The BusinessNZ Economic Conditions Index (ECI) sits at 6 for the June 2012 quarter, up 2 from the previous quarter and down 7 on a year ago. While still in positive territory overall, both quantitative and qualitative data show mixed results.

Global markets remain volatile with uncertainty now a significant factor in business planning for the foreseeable future as countries struggle (largely unsuccessfully to date) to address unsustainable levels of debt.

The international economic outlook has slowed further with commodity prices continuing to take a hit, impacting on NZ's terms of trade.

Business and consumer confidence remain in positive territory but confidence levels appear to be increasingly de-coupled from official economic statistics.

Households and businesses continue to take a cautious approach to new investment and debt reduction is still a high priority for households and businesses.

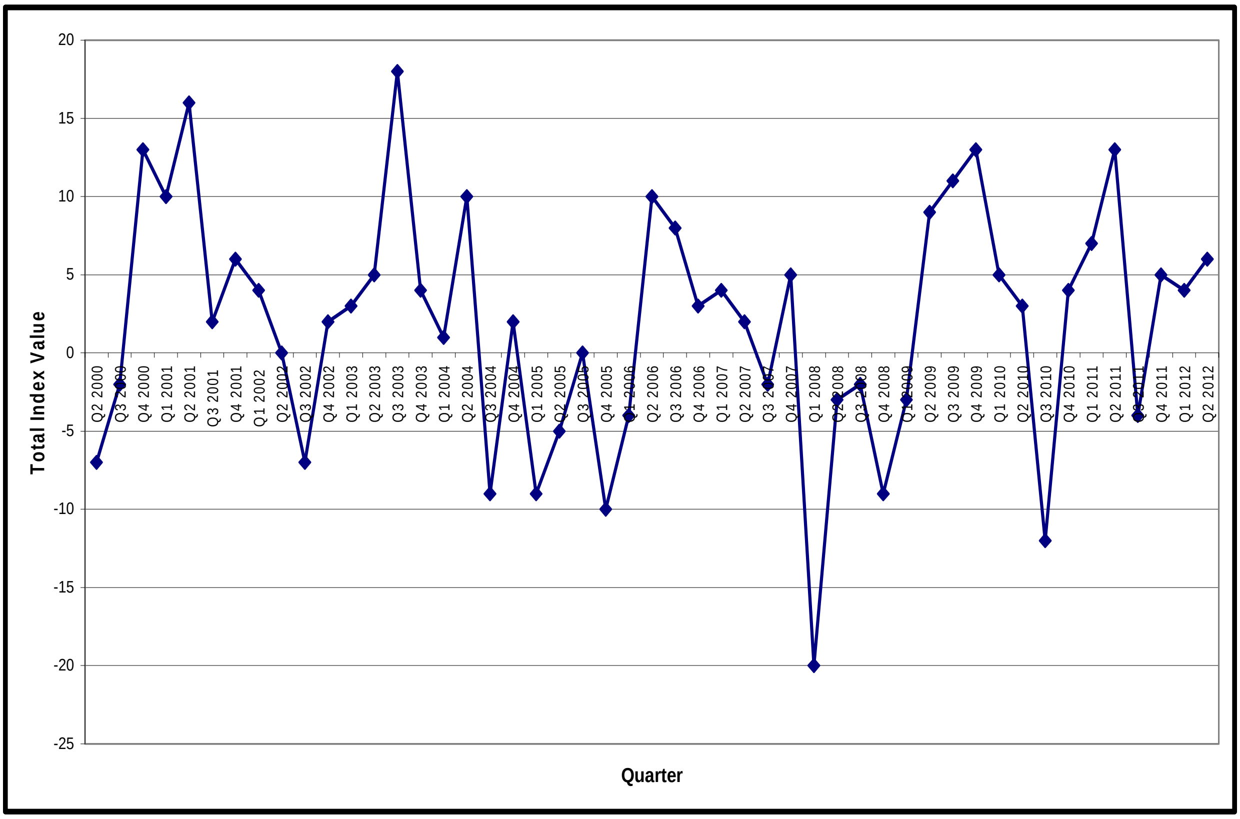
The Government's recent 'zero' budget could be considered fiscally responsible, although business would have liked to see a greater focus on addressing low quality expenditure such as interest-free student loans. As well, the Government seems content to leave the whole NZ Superannuation entitlement debate firmly on the back-burner.

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 6 for the June 2012 quarter, up 2 from the previous quarter and down 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 2 for the June 2012 quarter, as at the last quarter and up 2 on a year ago. Continued reductions in international commodity prices are impacting adversely on NZ terms of trade with merchandise terms of trade falling 2.3% in the March 2012 quarter compared with the December 2011 quarter.

[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>Monetary policy/pricing indicators</u> sit at 0 for the June 2012 quarter, up 4 on the last quarter and down 2 on a year ago. Inflationary pressures remain subdued with the likelihood that historically low interest rates will continue until well into 2013.

<u>Business/consumer confidence indicators</u> sit at 3 for the June 2012 quarter, down 8 on the previous quarter and down 6 on a year ago. While still firmly in positive territory, reported business and consumer confidence is generally not being reflected in expansion.

<u>Labour market indicators</u> sit at 1 for the March 2012 quarter, up 2 on the previous quarter and down 1 on a year ago. Both official and forward looking indicators continue to support the view that, in net terms, the labour market is largely moving sideways, although there are significant pockets of optimism e.g. Christchurch, associated with the rebuild effort.

<u>Part 2: The New Zealand economy – where are we going?</u>

1.1. Economic growth (GDP) – slow grind

While there are obviously differences around the margins, both private sector forecasters and the Treasury, are predicting growth of around 3% per annum out to 2014.

Forecasts: Real GDP % Growth

	Years Ending		
	Jun 12	Jun 13	Jun 14
Highest	1.9	3.0	3.5
Average	1.3	2.4	3.0
Lowest	0.7	2.1	2.3

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

Although it could be argued that 3% growth is hardly spectacular given NZ's mediocre growth rate since the Global Financial Crisis (GFC) in 2008, there are potentially downside risks to even 3% growth generation, for a number of reasons.

First, the rebuild of Christchurch is a big factor which will make or break the forecast for growth. On the one hand, delays to extensive rebuilds have already pushed out the optimism for growth but continued delays over key issues such as insurance payouts and the obligations on various parties, combined with ongoing significant aftershocks, may delay building work even further. Currently, it is as if everyone is waiting for the starter's gun but is not exactly clear when it will go off.

Second, international commodity prices, have taken a serious hit over the last six months or so and this is impacting adversely on NZ's terms of trade. Fonterra continues to reduce its forecast payout for the 2011/12 with the latest being a 30 cent reduction from $6.75 to $6.45 before retentions. Fonterra has also announced a lower opening forecast payout for the coming 2012/13 season of between $5.95 and $6.05 before retentions.

Given high levels of on-farm debt and a strong focus on reducing debt to more manageable levels, the latest reduction in forecast payouts could encourage farmers to tighten the expenditure screws further. Obviously, this will have flow-on impacts for rural communities and ultimately urban centres as well.

Third, businesses and consumers can to some extent be perceived, currently, as being like possums in the headlights, not knowing what to do given the conflicting economic data coming from international as well as from domestic sources. This is inducing a very cautious approach to new investment, with a continuing focus on debt reduction by both businesses and households.

Positive business and consumer confidence is simply not being reflected in actual investment and expenditure decisions. Traditional measures of consumer optimism, such as retail sales and electronic transactions, remain relatively flat, while producing any upswing in building activity is proving to be a slow grind.

Pockets of suggested optimism in the housing market need to be taken with a grain of salt, as asking prices and numbers of listings do not necessarily translate in actual sales or improvements in prices.

Fourth, the net outflow of permanent and long-term migrants is a significant issue for NZ, particularly in terms of the potential loss of skills to Australia (where net inflows from NZ have reached an all-time high of close to 40,000 per annum). This will put pressure on the ability of NZ to supply the number of skilled workers required for the rebuild of Christchurch.

All in all, not a particularly rosy picture. However, compared with many other countries, NZ is doing pretty well, so the situation needs to be put into perspective.

1.2 Monetary Conditions – global challenges continue to weigh heavily

Interest rates – on hold for longer

The 90-day bill rate is forecast to increase slowly and reach 3.3% by June 2013 and 4.1% by June 2014, as evidenced in the forecasts below.

Forecasts: Interest Rates (90 day bills)

	As at end of		
	Jun 12	Jun 13	Jun 14
Highest	2.8	3.5	4.4
Average	2.8	3.3	4.1
Lowest	2.7	3.2	3.7

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

With inflationary pressures low, pressures on commodity prices easing, and relatively subdued household demand, the case for any interest rate rises in the foreseeable future is very slim.

Nevertheless, there is a possibility that tighter controls on the banking sector, implemented through the Reserve Bank's prudential requirements, could see interest rates move up slightly for some sectors, although the impact is likely to be marginal given that already NZ banks largely comply.

The conclusions of the New Zealand Institute of Economic Research (NZIER) Shadow Monetary Policy Board (whose task it is to recommend interest rate settings ahead of each decision by the Governor of the Reserve Bank of NZ) found the majority still supporting 'no change' to the Official Cash Rate (OCR).

Therefore, despite calls from some people for reductions in the OCR, this would appear to be highly unlikely unless the situation in Europe turns decidedly worse. The Reserve Bank will likely wish to retain some ability to lower rates should extraordinary circumstances require it.

The New Zealand dollar – volatility will continue on the back of global uncertainty

Forecasts below show the NZ dollar is likely to fluctuate significantly. The Government's Budget 2012 figures on the exchange rate were largely out of date by the time the Budget was officially released. This is through no fault of the forecasting skills of Government officials but simply underpins the huge difficulty of making predictions about the future direction of the dollar, given the potential for global influences to impact significantly on it.

Forecasts: Exchange Rates

	AUD (cents)		
	Jun 12	Jun 13	Jun 14
Highest	0.785	0.835	0.820
Average	0.778	0.803	0.801
Lowest	0.770	0.780	0.775

	USD (cents)		
	Jun 12	Jun 13	Jun 14
Highest	0.790	0.840	0.850
Average	0.776	0.825	0.783
Lowest	0.760	0.800	0.730

	TWI		
	Jun 12	Jun 13	Jun 14
Highest	72.6	74.8	73.4
Average	70.7	73.6	71.6
Lowest	69.2	71.5	68.9

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

Clearly, global risks have been partially responsible for the easing of the NZ dollar of late, along with the more profound issue of the easing in world commodity prices. Given NZ's fortunes are firmly tied to international commodity prices; it is not surprising that historically, the NZ dollar has tended to follow the fortunes of international commodities. In this respect, some further easing may be possible.

Inflation - pressures subdued in the short-term but pressures may build in out-years

Forecasts outlined below show inflation as likely to be well within the Reserve Bank's target range of 1-3% for the year to June 2013, although that limit will be under pressure in the year to June 2014 when inflation is forecast to reach 2.8%.

Several factors continue to put downward pressure on inflation in the near term.

First, a relatively subdued global economic outlook is taking pressure off resources.

Second, international commodity prices continue to ease which will eventually flow through into domestic price reductions (or at least mean minimal rises).

Third, strong competition in the domestic market has resulted in profit margins being slashed with many businesses relying on heavy discounting to make a sale.

Fourth, net migration outflows will take further pressure off resources, including housing, although over the longer term they could impact adversely on the quality and size of the labour market – particularly increasing the demand for skilled trades people as the Christchurch rebuild gains momentum.

Despite subdued inflationary expectations, the coming years could see some upward pressure on household budgets generated by the increasing cost of insurance (health and property-related) as a result of the Christchurch earthquakes and a general re-pricing of insurance risk. And new building standards, also driven largely by the Christchurch earthquakes, could add substantially to housing costs.

On the other hand, the recent Productivity Commission report on Housing Affordability put strong emphasis on the need to free up land for housing and if Councils take up the Commission's recommendations, households may well be able to anticipate cheaper housing packages in the future. In this respect, it is important that pressure is put on both central and local government to implement the report's key recommendations.

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Jun 12	Jun 13	Jun 14
Highest	1.4	2.3	3.4
Average	1.2	2.1	2.8
Lowest	1.1	1.5	2.5

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

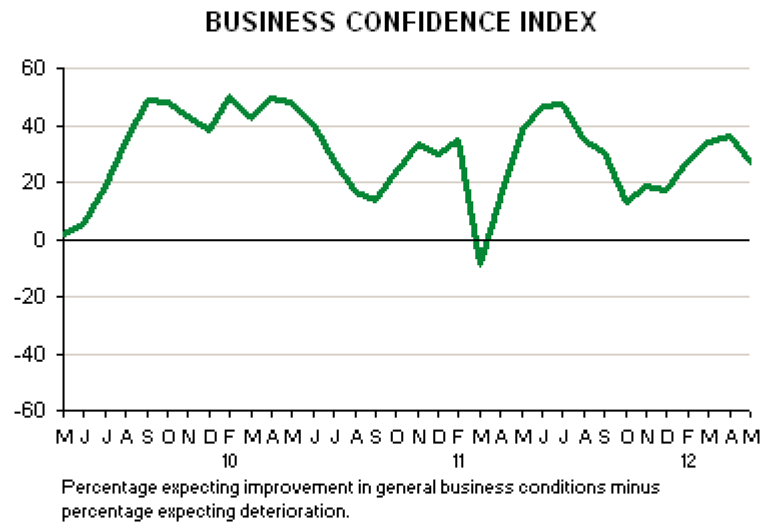
1.3 Business and consumer confidence – disconnect between confidence and reality?

Business confidence – results need to be taken with a grain of salt

A number of surveys show business confidence generally well on the positive side of the ledger. The disappointing issue is that improved business confidence does not appear to be translating into higher levels of investment and employment growth. Over the last 2-3 years there seems to have been a decoupling of business (and consumer) confidence and actual growth levels. In the past, there was a very strong correlation between the two but since the GFC in 2008 this relationship has largely gone out the window with businesses taking some time to get to grips with the fact that for the future, the new certainty is global uncertainty.

The National Bank's Business Outlook (May 2012) shows a net 27% of businesses expecting better times for the economy over the coming year, down from a net 36% a month ago. All sectors bar construction showed an easing in business sentiment. Nevertheless, despite the latest dip, business confidence still remains well above its historic average.

National Bank Business Confidence Index



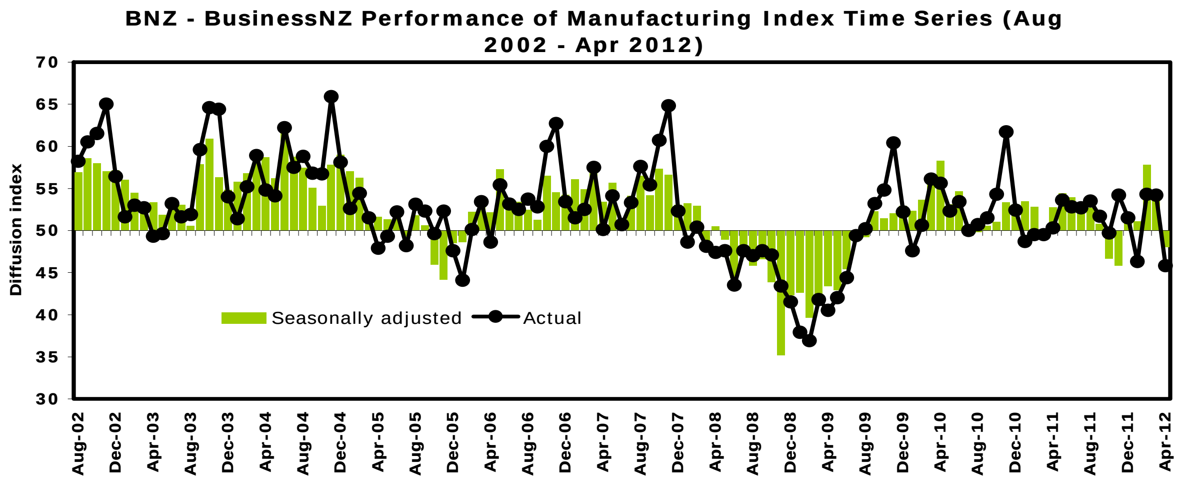
Firms remain relatively positive about their own activity outlook with a net 35% expecting an improvement (down 1 percentage point on the previous month).

The above is consistent with a cautious business theme as investment intentions eased from +18 to +12 while export intentions showed a net 15% of businesses expecting a lift in export volumes (a net 23% the previous month).

These expectations are also consistent with what is coming through in respect to official trade data.

Other indicators of business confidence show mixed results.

The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) started the 2012 year with generally positive results with a 'high' of 57.8 recorded for the month of February. March saw this result slip slightly to 53.8, and then the wheels tended to fall off in April with a reading of 48.0.



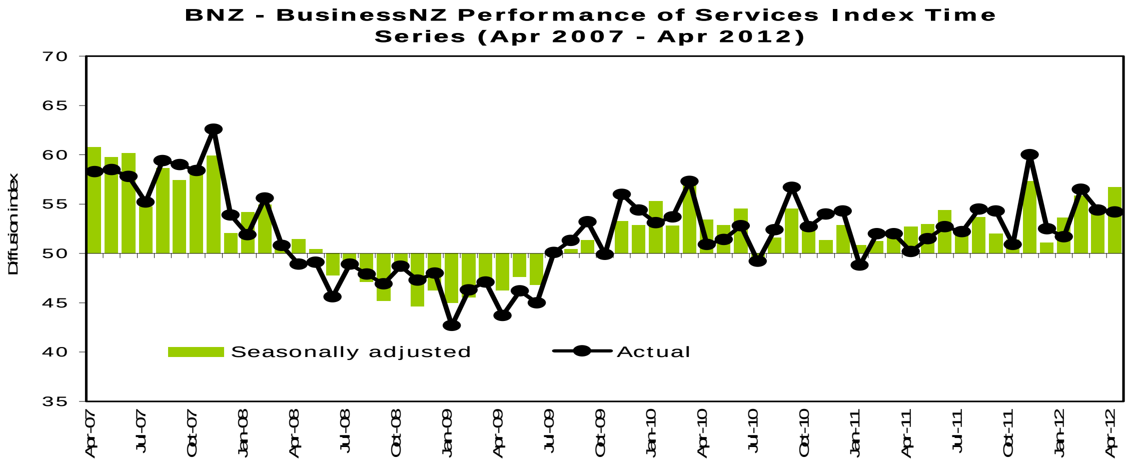
Source: BusinessNZ

Despite the fall in overall activity, two of the five seasonally adjusted diffusion indices were in expansion in April. However, both *production* (44.6) and *new orders* (48.5), which make up the greatest weight of the overall result, fell into decline. Conversely, *employment* (51.2) remained relatively stable, with a result that has moved by only one point over the last four months. This is consistent with other employment-related data and shows very modest employment growth and relatively stable levels of unemployment.

Deliveries (46.3) fell into decline after four months in expansion, while *finished stocks* (50.3) showed slight expansion after three months in contraction.

Obviously one should not read too much into the results for one month but the weakness in the key indices (*production* and *new orders)* gives of cause for concern. On the other hand, the drop in the NZ dollar of late may give manufacturing a much need shot in the arm over coming months. It is certainly not appropriate to be pessimistic at this stage, given the yo-yo effect over the past 6 months or so.

The seasonally adjusted BNZ-BusinessNZ Performance of Services Index (PSI) for April 2012 (56.7) continues its relatively strong run since the start of 2012. The latest result was up 2.5 points from March, the highest result for any month since November 2011. Compared with previous April results, it was also the second highest since the survey began in April 2007.



Source: BusinessNZ

All five seasonally-adjusted indices which make up the PSI showed expansion in April. This was again led by *new orders/business* (60.5), which has remained in a relatively tight band of activity since the start of the year. *Activity/sales* (56.1) bounced back from a drop in March, while *employment* (55.1) showed further strength by displaying its highest level of activity since June 2007. Both *stocks/inventories* (53.8) and *supplier deliveries* (54.7) recorded levels of expansion not seen since July 2008 and September 2007 respectively.

Other sectors remain mixed. Optimism in the agricultural sector has taken a hit after a prolonged period of positive outcomes on the back of high commodity prices and relatively favourable growing conditions. Debt reduction is likely to be an even greater focus for this sector in coming months, now that commodity prices are continuing to drop.

The retail and tourism sectors are generally flat but construction is starting to gear up with the rebuild of Christchurch encouraging a shift of resources into that region.

Consumer confidence – still in positive territory but strong element of caution evident

Consumer confidence remains in positive territory but results show an underlying theme of continued caution with a strong focus on debt reduction and wallets tucked firmly away.

The ANZ-Roy Morgan NZ Consumer Confidence Survey (May 2012) shows consumer confidence largely unchanged from the previous month at 113.9, indicating consumers as still relatively nervous, with their concerns influencing general expenditure patterns.

Other indicators of consumer confidence e.g. retail sales and electronic transactions, continue to be subdued with business profits squeezed in light of consumer reluctance to spend.

Given consumer confidence is closely related to current and future employment prospects, the drifting nature of labour market outcomes at the moment is perhaps adding to the caution evidenced in recent consumer behaviour.

The one positive result is that finally the need to rein in expenditure debt seems to be bearing fruit although the question remains as to whether households are being almost too cautious. Household debt has certainly taken a tumble from the rampant growth experienced in the mid-2000s.

Household debt, as a percentage of disposable income has fallen from close to 160% in 2007 to around 140% currently. Debt reduction has been significantly assisted by historical low mortgage interest rates and debt-servicing costs have dropped from around 15% of disposable income in 2008 to around 8% currently. With the prospects of low interest rates remaining for some time to come, the opportunity exists for NZ households to get overall debt down to more manageable levels, minimising the risk of any change in international investor sentiment towards NZ.

1.4 Labour market – moving sideways

Employment – slowly slowly

Forward-looking indicators clearly point to relatively slow employment growth with unemployment expected to drift lower over time as evidenced in the forecasts below.

The ANZ job ads series, which sums newspaper and internet job ads, fell 2.0% in April (on a seasonally-adjusted basis), following a 0.9% fall in March. While clearly there are pockets of strong optimism, e.g. Christchurch, the overall result is one of slow progress on the employment front. This is consistent with other surveys such as the PMI and PSI.

Treasury forecasts for both employment and unemployment outlined in the recent Budget appear to be overly optimistic, forecasting employment growth of around 1.5% over the period to 2016. Unemployment is expected to reach 4.7% by 2016, which seems a pretty heroic forecast.

Forecasts: Unemployment % (HLFS)

	Quarter		
	Jun 12	Jun 13	Jun 14
Highest	6.5	6.1	5.9
Average	6.5	5.9	5.5
Lowest	6.4	5.5	5.0

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

Labour costs – subdued but upward pressure in some sectors

Forecasts below indicate that labour costs are expected to increase slowly to around 2.4% for the year ending June 2014. 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 predicted by most forward-looking surveys.

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.

According to the Hays 2012 Salary Guide, around two thirds of employers plan to offer salary increases of less than 3% when they next review pay levels. The Guide shows that 63% of employers intend to increase salaries by less than 3%, while 22% will provide increases of between 3-6%. 9% of employers no not intend offering any increases.

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

	Years ending		
	Jun 12	Jun 13	Jun 14
Highest	2.2	2.5	2.8
Average	2.1	2.0	2.4
Lowest	2.0	1.5	2.1

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