BUSINESS NZ

PLANNING FORECAST

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BusinessNZ

The economy – down a gear as risks remain

Executive summary

NZ's economic fundamentals are pointing in the right direction but the rate of growth is slowing, as indicated by both quantitative and qualitative data.

The agricultural sector, and particularly dairy, continues to face head winds with international oversupply still likely to keep downward pressure on prices for some time to come. GlobalDairyTrade auctions continue to show slippage although not the free-fall experienced earlier in the year. NZ farmer confidence has slumped to its lowest level in a decade (for the June 2015 quarter) with a net 45 percent being negative, after a net 13 percent were positive in the first quarter, according to Rabobank's latest rural confidence survey.

International confidence is largely subdued with our two largest trading partners, Australia and China, showing slower growth than in the past. NZ's dependence on these to markets for around 40 percent of our export trade has certainly impacted on the NZ growth rate. On the other hand, economic data coming out of the world's largest economy, the US, has continued to improve of late with a wide range of data supporting an improving economy.

Business investment and business investment intentions – a key indicator of future growth - have taken a bit of a hit over recent times. Another key indicator, the ANZ's Truckometer which measures vehicle freight movements, has also been subdued of late, suggesting economic growth is likely to have a 2 in front of it rather than the 3+ that many forecasters had expected up until recently.

On the other hand, the construction sector is still showing positive growth and the services sector remains healthy, according to the BNZ-BusinessNZ Performance of Services Index (PSI). Its sister survey, the BNZ-BusinessNZ Performance of Manufacturing Index (PMI), is still showing solid growth, despite recent unevenness in expansion.

Inflation is for all intents and purposes dead, notwithstanding some domestic pressures remaining particularly in the housing market in Auckland, driven by continued strong net inward migration.

The NZ dollar has hit a fresh five-year low with expectations for more interest rate cuts, following lower than expected GDP growth for the March 2015 quarter. Improving economic data in the US will strengthen the case for interest rate rises in that country, which may add further downward pressure on the NZ dollar.

The labour market is still showing significant growth although employment growth is being largely offset by increasing numbers of people entering the labour market.

The recent 2015 Budget shows the Government slowly getting its accounts in order, with the likelihood of a Budget surplus just around the corner.

The Government's recent announcement of proposed (well overdue) cuts in Accident Compensation levies by around $500 million over the next couple of years was very welcome. It effectively represents a tax cut for businesses, earners, and motor vehicle owners. Perhaps even more important is the introduction of a new Accident Compensation (Financial Responsibility and Transparency) Amendment Bill aimed at ensuring that levies reflect sound insurance principles. This is a major step forward towards ensuring that public trust in ACC is maintained and the Government of the day is held to account. It makes no sense for ACC levies to be maintained at artificially high rates to achieve unrelated objectives of Government, such as achieving a paper surplus.

HIGHLIGHTS

The BusinessNZ Economic Conditions Index (ECI) sits at 1 for the June 2015 quarter, down 3 on the previous quarter and the same as a year ago.

The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey the BNZ-BusinessNZ Performance of Services Index (PSI) show continued growth, despite some unevenness over recent months.

Indicators of business and consumer confidence remain positive, although sentiment has dropped slightly over more recent months. Investment intentions have reduced recently.

The construction sector continues to perform strongly in the context of the Christchurch rebuild, Auckland housing, and flood-related damage to various parts of the country over recent weeks and months.

Sentiment in the agricultural sector has dived in light of continued reductions in commodity prices, notably dairy, which will ultimately be felt beyond rural NZ, especially in service industries.

Regional variations and sub-regional variations in activity continue to persist, with no easy solutions to complex issues driving lower growth in some regions.

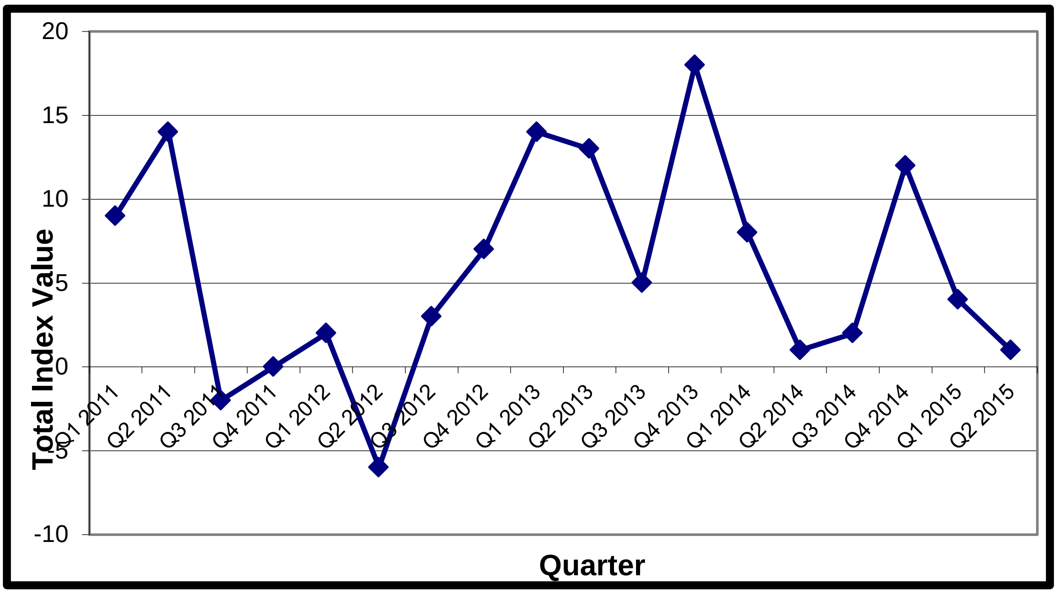
Despite some pockets of inflationary pressures, overall inflation as measured by the Consumers Price Index remains subdued with the likelihood of further interest rates cuts helping to drive the NZ dollar lower.

PART 1: THE NZ 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 1 for the June 2015 quarter, down 3 on the previous quarter and the same as 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

Of the ECI sub-groups:

<u>Economic growth/performance indicators</u> sit at 3 for the June 2015 quarter, up 4 on the last quarter and up 2 on a year ago. A continuing slide in international commodity prices, particularly dairy, continues to impact on NZ's terms of trade. However, a continued drop in the NZ dollar will boost returns to exporters when converted back into NZ dollars.

<u>Monetary policy/pricing indicators</u> sit at -1 for the June 2015 quarter, down 3 on the last quarter and up 1 on a year ago. Limited inflationary pressures reinforce the likelihood of further interest rate cuts which, along with other factors, is driving the NZ dollar lower.

<u>Business/consumer confidence indicators</u> sit at -3 for the June 2015 quarter, down 2 on the previous quarter and the same as a year ago. Business and consumer confidence is still positive but continues to slide from a relatively high base. Business investment intentions have drifted lower over recent times; not particularly good news for future growth prospects given that the intention to invest is a key indicator of future economic growth.

<u>Labour market indicators</u> sit at 2 for the June 2015 quarter, down 3 on the previous quarter and the same as a year ago. The labour force participation rate continues to break new records and is a key indicator of labour market strength. On the other hand, increased numbers entering the labour market means that while employment growth is still relatively robust, the unemployment rate has hardly moved over recent months.

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[1] The ECI tracks over 30 indicators on a quarterly basis. The overall index value for any particular quarter represents the net balance of the 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.

PART 2: THE NZ ECONOMY – WHERE ARE WE HEADING?

1.1 Economic growth (GDP) – plateaued

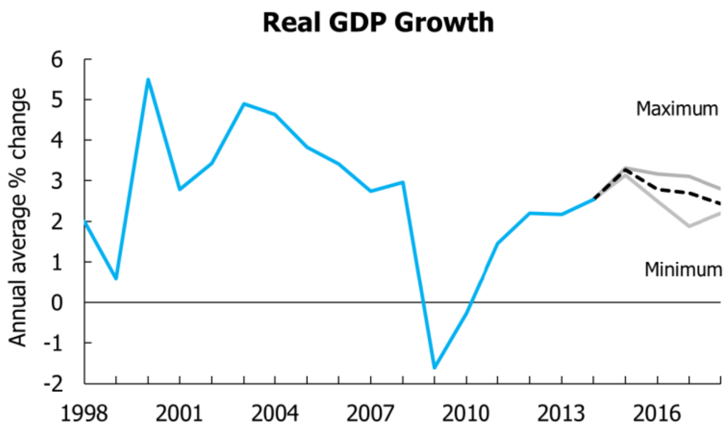
Growth of around 2.5 percent is forecast out to June 2017 (see below).

Forecasts: Real GDP % Growth

	Years Ending		
	Jun 15	Jun 16	Jun 17
Highest	3.2	2.9	3.3
Average	3.1	2.6	2.6
Lowest	2.7	2.3	1.7

Source: ANZ, ASB, BNZ, and Westpac

The Consensus forecasts released recently by the NZ Institute of Economic Research are slightly more optimistic, picking growth of around 2.8 percent in the March 2016 year and 2.7 percent in the following year.



Source: Statistics NZ, NZIER

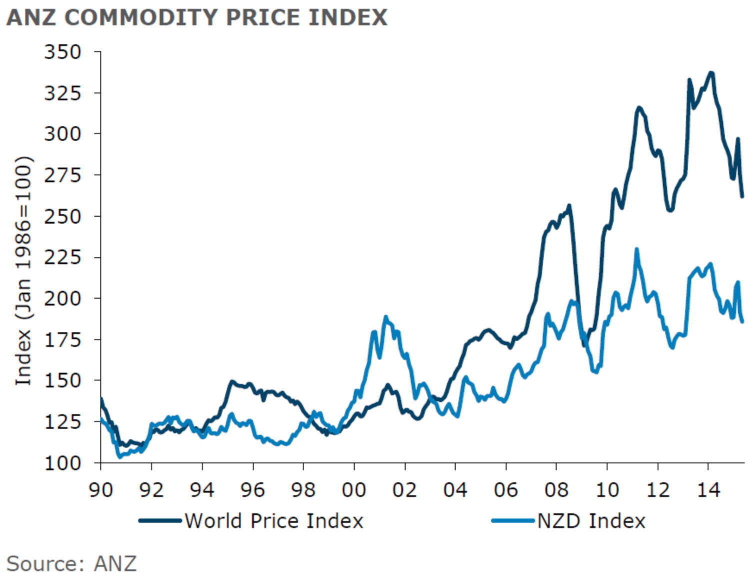
Strong residential construction is a key contributor to current growth rates. Construction activity is likely to be pared back over time.

Improving household incomes on the back of positive labour market outcomes should support further household spending. Reductions in interest rates will also assist this, along with further reductions in ACC levies which will be welcomed by earners, businesses and motorists. The Government has proposed a reduction in levies of around $500 million over the next couple of years.

The services sector remains very healthy according to the BNZ-BusinessNZ Performance of Services Index (PSI). Its sister survey, the BNZ-BusinessNZ Performance of Manufacturing Index (PMI), is still showing solid growth, despite recent unevenness in expansion.

In terms of exports, dairy has taken a big hit over recent months and there is still some degree of uncertainty over export volumes and prices. This uncertainty has been reflected in a doubling of farmers taking up Fonterra's guaranteed milk price offer for next season, which it is understood has been oversubscribed. Prices are likely to remain subdued over the next year until international stocks are run down.

The ANZ Commodity Price Index for May 2015 declined by 4.7 percent. The index is now 18 percent lower than 12 months earlier and 22 percent below its February 2014 peak. A lowering in the NZ dollar should at least partially offset in the decline in commodity prices when converted back into NZ dollars.



Other key forward-looking indicators show growth moderating as well, as evidenced by the ANZ Truckometer, a key measure of economic activity using real-time traffic.

Regional growth patchy

While overall growth continues to remain relatively buoyant, particularly compared with other developed countries, there are still concerns regarding to regional outcomes, with some regions booming while others continue to experience low growth. There are many reasons low growth in some regions, and no easy answers. While there are some obvious reasons for some of the current discrepancies in activity (the Canterbury rebuild for example), from a wider perspective regional issues can reflect both economic and regulatory/policy issues.

Economic issues resulting from international, technological and consumer changes are impacting heavily on regional areas:

- **Business decline** - internationalisation of markets means inefficient businesses are no longer propped up, hastening the decline of some regional businesses.
- **Reduced incentives for business to invest** – slow population growth and slow growth of enterprises in some regions are reducing the potential for economies of scale, bringing reduced incentives to invest.
- **Reduced demand for local products** – the ability to readily source products from larger centres, and internationally via internet trade is reducing demand for some local products.
- **Reduced demand for unskilled labour** – regional agricultural production and processing is becoming more technological, reducing demand for unskilled labour.
- **Infrastructure decline** – in some regions existing infrastructure is no longer fit for purpose and the regional population base is insufficient to fund upgraded infrastructure.
- **Risks from central government underinvestment** – underinvestment brings a risk of diminishing access to education opportunities and reduction in scope and quality of services such as hospitals, ACC rehab etc, which will eventually put compensatory pressure on larger centres.

As well, regulations and policies developed at national level may be bringing unintended consequences in regional areas:

- **Barriers to development of natural resources** – some resource-rich regions are unable to attract development ventures because resource legislation (RMA, Crown Minerals Act, EEZ Act, Local Government Act) creates uncertainty around the ability to gain consents.
- **Inefficient water use** - lack of certainty around rights to use water is restricting incentives to invest in regional development and preventing water being allocated efficiently to its highest-value uses.
- **Inappropriate regulation** – regulation that restricts activities, reduces innovation or growth prospects, or imposes unnecessary costs may have disproportionate effects in the regions e.g. earthquake strengthening regulations impacting on regional viability.
- **Inadequate labour supply** – immigration and visa policies set at a national level may not align fully with regional needs; varied regional industries e.g. horticulture, dairying, viticulture, have different seasonal labour needs.

Some issues outlined above can be addressed most effectively by businesses, some by local communities, some by Government and some by households and individuals themselves, while many require a shared responsibility approach.

1.2 Monetary conditions – further easing likely in the short term

Interest rates – drifting lower

The 90-day bill rate is forecast to decline slightly for the year to June 2016 and then regain some ground out to June 2017 (see forecasts below).

Forecasts: Interest Rates (90 day bills)

	Years ending		
	Jun 15	Jun 16	Jun 17
Highest	3.3	3.2	3.7
Average	3.2	3.1	3.5
Lowest	3.2	3.1	3.1

Source: ANZ, ASB, BNZ, and Westpac

The Reserve Bank reduced the Official Cash Rate to 3.25 (down from 3.5) in its latest review. Significantly, it has left open the door to further interest rate cuts if new economic data justify such a position. The call to reduce rates was largely considered by markets to be a 50:50 call with the NZ Institute of Economic Research's Shadow Monetary Policy Board favouring by the narrowest of margins that the Reserve Bank leaves the OCR on hold. There was 53 percent support for leaving the OCR at 3.5 percent and 40 percent support for a cut. This close call was based on the balance of inflationary and deflationary pressures in the NZ economy.

On the downside, the outlook for the economy is not so bright, particularly regarding commodity prices, notably dairy, which will drive down demand in rural NZ.

Import prices continue to slide, while domestically made goods and services remain at subdued levels, apart from isolated pockets, particularly in non-contestable markets (e.g. proposed local government rates increases).

Despite solid labour market outcomes, wage pressures remain under firm control.

On the other hand, Auckland's housing market continues to boom ahead for a number of well-known reasons, including a lack of new land being made available for housing, regulatory overkill (as outlined in the recent Draft Report by the NZ Productivity Commission report *Using Land for Housing*), and high net inward migration forcing up demand.

A recent slide in the value of the NZ dollar against many other major trading partners raises the likelihood of imported prices rising over time as a result.

Given that the Reserve Bank is looking out a couple of years in terms of its price stability objectives, it faces a difficult path in either making further cuts to the OCR or keeping rates on hold given the current two-speed nature of the NZ economy.

The NZ dollar – slip sliding away

Forecasts show the NZ dollar is generally expected to slide against the Australian and US dollars, although predicting the future direction of the NZ dollar is difficult, depending on which assumptions are built into models, as the widespread differences below indicate.

The Australian economy is still in a relatively low growth phase with uncertainty at the political level also influencing confidence.

Monetary policy in the US remains lax, with prospects of interest rate rises to arrest the slide in the US dollar continuing. Notwithstanding, economic data coming out of the US continues to improve and reflects a growing confidence going forward. This may put some upward pressure on interest rates and help lower the NZ dollar further.

Forecasts: Exchange Rates

	AUD (cents)		
	Jun 15	Jun 16	Jun 17
Highest	0.91	0.92	0.91
Average	0.90	0.91	0.88
Lowest	0.89	0.90	0.86

	USD (cents)		
	Jun 15	Jun 16	Jun 17
Highest	0.74	0.71	0.74
Average	0.71	0.67	0.68
Lowest	0.70	0.65	0.66

TWI			
	Jun 15	Jun 16	Jun 17
Highest	76.0	74.0	72.0
Average	74.7	72.1	70.8
Lowest	72.7	70.8	68.9

Source: ANZ, ASB, BNZ, and Westpac

Inflation – a game of two halves

Forecasts below show inflation firmly under control over the period to March 2017, remaining well within the Reserve Bank's target range of 1-3 percent.

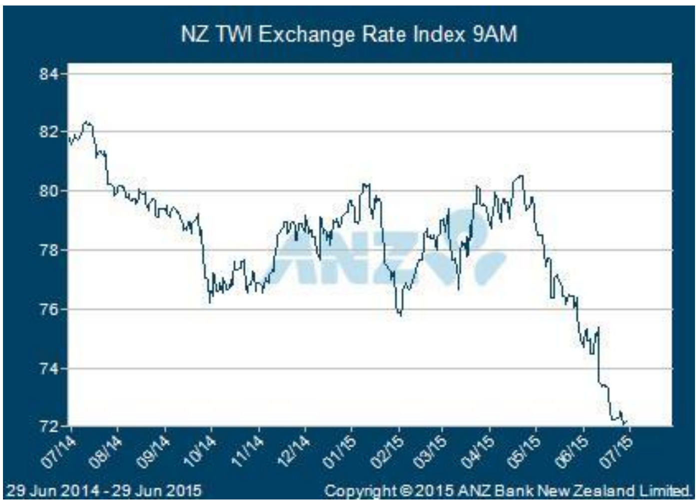
Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Jun 15	Jun 16	Jun 17
Highest	0.6	2.2	2.5
Average	0.5	1.8	1.9
Lowest	0.2	1.3	1.5

Source: ANZ, ASB, BNZ, and Westpac

Some upward pressure is occurring as a result of house price rises and relatively strong domestic demand (including relatively high levels of net inward migration), although wage pressures from a significantly improved labour market have yet to have any material impact. In fact for the last year or so, wage increases have been relatively subdued with little real movement. But downward inflationary pressures are dominating, the product of reduced international commodity prices (mainly dairy and oil), and a still relatively elevated $NZ taking the heat out of any pressure from the tradeables sector.

The relative decline in the NZ dollar against our major trading partners, as measured by the trade weighted index, would suggest some upward heat on prices. A considered decline in the NZ dollar is probably better than a sudden drop in terms of the Reserve Bank's mandate to maintain price stability.



1.3 Business activity and consumer confidence – edging lower but still positive

Business activity – consolidating at lower levels

Key indicators of business activity and confidence show consolidation, but at lower levels.

In summary, business survey data generally show businesses as still reasonably optimistic about their own business prospects, the most important indicator of future GDP growth. Businesses are less optimistic about the general economic situation.

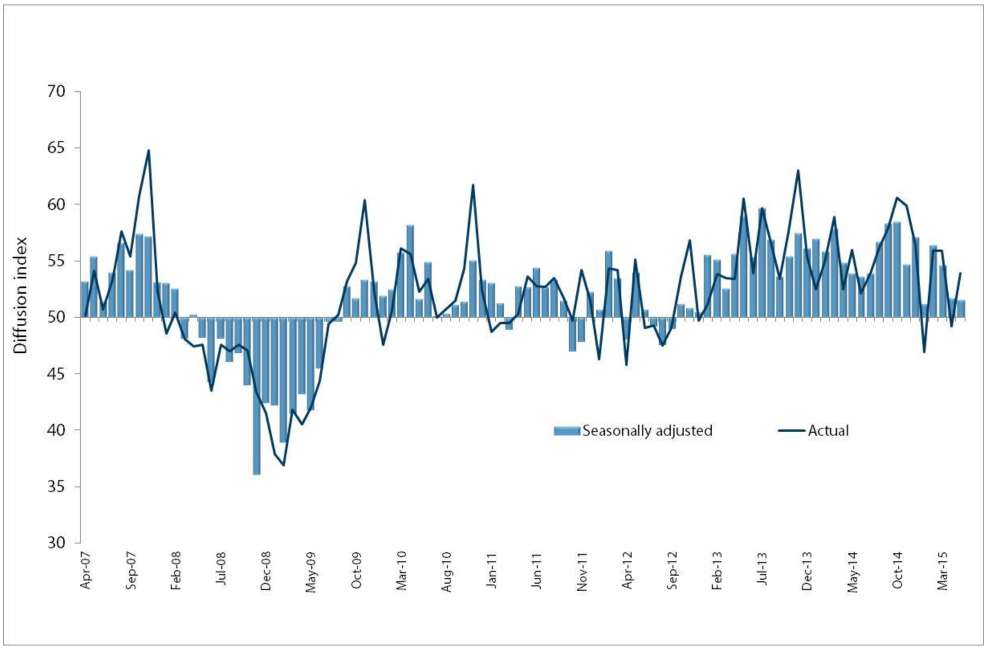
A number of surveys show that investment intentions have drifted lower; not necessarily a desirable outcome given that intention to invest is a key forward-looking indicator of future growth prospects.

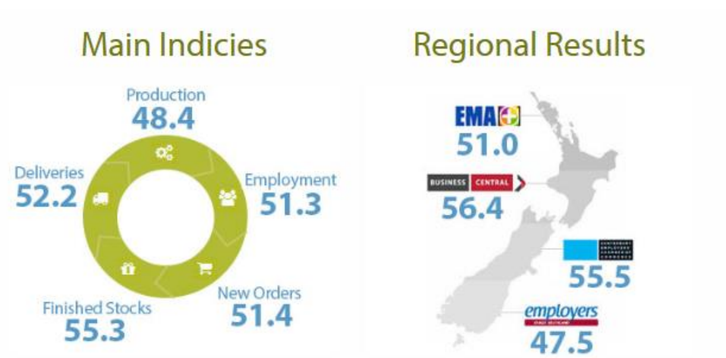
Obviously, sentiment in different sectors varies widely, from optimism in the construction industry through to pessimism in the agricultural sector, notably dairy, in light of a relatively sharp lowering in commodity prices over the last year, and uncertainty as to when prices might improve.

However, it is certainly not all doom and gloom. The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and BNZ-BusinessNZ Performance of Services Index (PSI) show continued growth, despite some unevenness over recent months.

The seasonally adjusted PMI for May was 51.5 (a reading above 50.0 indicates that manufacturing is generally expanding: below 50.0 that it is declining). This was 0.2 points lower than April, and the third time in five months that the PMI has been in the 51.0-51.9 range. Despite another dip in expansion, the sector has still been in the expansion zone for 32 consecutive months.

BNZ-BusinessNZ Performance of Manufacturing Index (PMI)
(2007 onwards)



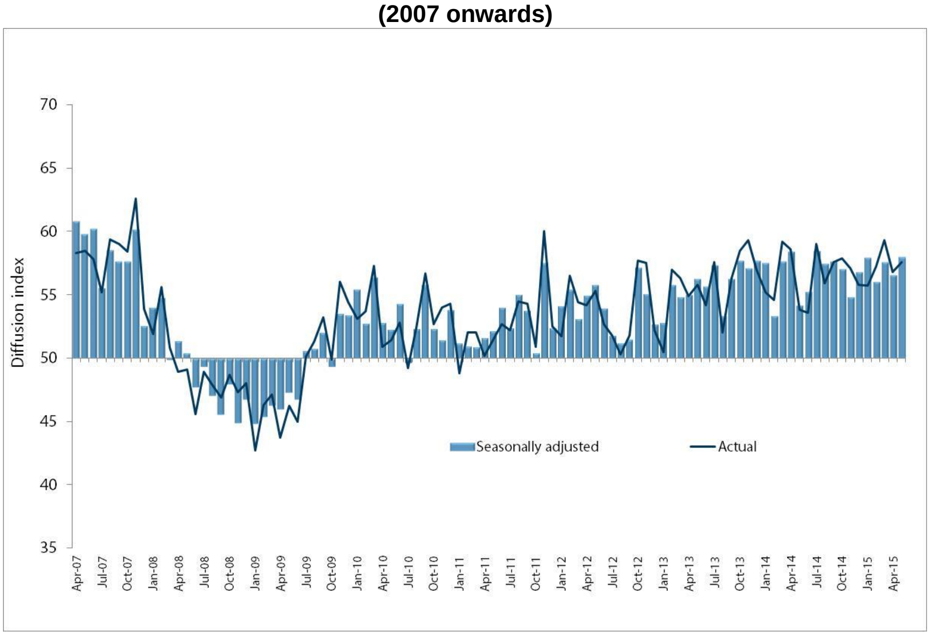


The proportion of negative comments for May (47.3 percent) was up again from the previous month (43 percent in April). Comments in May were along similar lines to last month in terms of the high value of the NZ dollar relative to the Australian (it has since dropped substantially), as well as comments about the lacklustre Australian economy. A number of respondents mentioned the lower dairy pay-out causing a decrease in new orders.

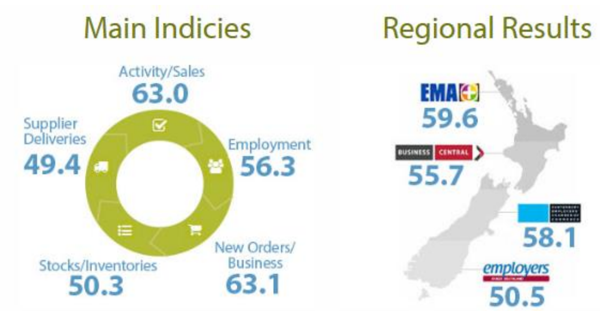
PMI's sister survey, the BNZ–BusinessNZ Performance of Services Index (PSI), continues strongly, with further expansion in May and key indices continuing to scale the heights.

The PSI for May was 58.0. This was 1.5 points higher than April and the highest overall value since July 2014 (A PSI reading above 50 indicates that the service sector is generally expanding; below 50.0 that it is declining).

BNZ-BusinessNZ Performance of Services Index (PSI)
(2007 onwards)



Indicators for *activity/sales* and *new orders* pushed further into the 60+ value range, indicating strong expansion is firmly in the pipeline.



It is also important to note that the employment index for May (56.3) reached its highest value since the PSI survey began in 2007. This, along with a boost in the proportion of positive comments from businesses (almost 70 percent) shows the services sector experiencing a bumper result in May.

Consumer confidence – a bob each way

Consumer confidence, like business confidence, continues to drift lower as evidenced by a number of regular surveys, although from a relatively high base. Consumer confidence is still above its historical average.

A number of factors are weighing on consumers' confidence at the moment, driving confidence to its lowest level since the middle of 2013.

Obviously, regional concerns with lower than expected dairy prices will adversely impact on regional demand for goods and services, a factor which was evident in the responses to the latest PMI.

Second, the kickstart from the rebuild of Christchurch is starting to wear off, although activity is still very high in the Canterbury region.

Third, while employment growth is still relatively strong, this is being largely offset with increasing numbers of people entering the labour market, bringing the labour force participation rate to a new high. Given the above, the unemployment rate has hardly budged over recent quarters.

Fourthly, the onset of winter may also be a factor weighing consumer confidence down.

Fifth, often like business confidence surveys there appears to be some discrepancy between how individuals are doing personally and what they consider are the wider prospects for the economy. This is reflected in responses from participants showing they generally believe their own financial position is improving but that of the wider economy is not.

On the other hand, inflationary pressures have continued to ease (with the possible exception of local government rates) with the likelihood for further interest rate cuts giving consumers a boost. Further out, the prospects of further cuts in ACC levies will also perhaps help raise confidence.

1.4 Labour market – solid performance

Employment – growth continues

Employment growth is still relatively strong although high numbers of people entering the labour market with record participation rates have not been associated with significant reductions in the percentage of unemployed. Unemployment is only expected to drop slightly down to 5.3 percent by June 2017, with associated reductions in unemployment as outlined below. The unemployment rate is expected to reach 5.3 percent by March 2017.

Forecasts: Unemployment percentage (HLFS)

	Quarter		
	Jun 15	Jun 16	Jun 17
Highest	5.8	6.0	6.3
Average	5.8	5.5	5.3
Lowest	5.7	4.9	4.6

Source: ANZ, ASB, BNZ, and Westpac

The Household Labour Force Survey official measure of unemployment tends to mask underlying labour market developments. For example, while employment growth was still relatively strong over the March 2015 quarter, the unemployment rate actually stayed at 5.8 percent (unchanged), the reason being record labour force participation rates.

The fact participation rates are at record levels shows that individuals and households have a degree of confidence in entering the labour market. In the past, the unemployment rate may have gone down but simply as a result of reduced participation rates as people voluntarily exited the labour market as conditions deteriorated.

Much of the employment growth over the past year was in full-time employment (up 60,000) while only 12,000 people entered part-time employment. The number of full-time positions available underlies the relative strength of the labour market.

The aggregate unemployment rate for NZ tends to seriously masks what is happening in particular regions, with official unemployment ranging from a low 3 percent in Canterbury to nearly double figures in Northland. Aggregate figures also understate outcomes for particular ethnic groups with the unemployment rate for Maori at 12.6 percent for the March quarter 2015. The overall NEET (not in employment, education, or training) rate for youth aged 15-24 years actually rose to 11.8 percent in the March 2015 quarter.

The BNZ-BusinessNZ PMI and PSI surveys still show solid growth in employment outcomes in the manufacturing and the services sectors. The employment sub-index for the PMI stood at 51.3 for the month of May 2015 and the PSI employment sub-index was 56.3, its highest value since the PSI survey began in 2007.

Other forward-looking surveys such as job advertising rates continue to show more modest growth, although there have been some monthly fluctuations. While the overall trend is up slightly, projections in the 2015 Budget for an unemployment rate of 4.6 percent by 2019 would appear optimistic.

Labour costs – steady

Forecasts below indicate that labour costs are expected to increase only slowly to 2.2 percent for the year ending June 2017.

Private sector salary and wage rates (including overtime) increased 1.8 percent in the year to March 2015 quarter. Public sector salary and wage rates (including overtime) increased 1.2 percent in the year to the March 2015 quarter.

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

	Years ending		
	Jun 15	Jun 16	Jun 17
Highest	1.8	2.2	2.5
Average	1.7	2.0	2.2
Lowest	1.6	1.7	1.9

Source: ANZ, ASB, BNZ, and Westpac