Business Planning Forecast - March 2008

Executive summary – mixed economic outlook but overall still positive

Economy

Overall, the New Zealand economy is in relatively in good shape and should be able to weather the flow-on effects associated with recent global financial market jitters. Indicators show that the economy has benefited from higher international commodity prices through strong global demand, although prices received by exporters have been blunted by a persistently high NZ dollar.

Improving terms of trade (largely on the back of the dairy boom), continued buoyancy in international commodity prices and ongoing strength in the labour market have been offset to some extent by rising interest rates and, more latterly, a rebound in the NZ dollar (particularly against the US). The drastic cuts in US interest rates to try and avert a recession have boosted interest in other high yielding currencies such as the Kiwi. The differential between interest rates in NZ and the remainder of the developed world is stark. This is principally for two reasons. First, inflationary pressures are still significant in NZ despite the housing market having slowed. Second, being large borrowers means overseas financiers want to ensure adequate return for investing in what are perceived to be more risky markets. Given the above factors, no early reduction in the dollar (or interest rates) in NZ is likely.

Business and consumer confidence continues to slide although there is a noticeable decoupling between business perceptions of the overall economy and individual activity levels. While business perceptions of the overall economy have continued to decline, business activity levels have stabilized or even risen slightly in many cases. This may reflect a general grumpiness with the government over a range of issues rather than factors directly impacting on business operations per se.

Consumer confidence, while slipping, is still reasonably robust although with the capital cost of housing having peaked while debt servicing costs continue to rise; a further drop in confidence is expected as the perceived wealth effects from a rapidly risking housing market over the last five years peters out.

A healthy labour market and tax cuts proposed in the 2008 Budget will offset some of the added costs facing households as a result of higher international fuel prices, increased food costs and the flow-on effects of the emissions trading scheme.

About the Business Planning Forecast Report

This bulletin is designed to help your business planning. It brings together forecasts of important indicators to help you prepare budgets and business plans. The forecasts are drawn from two main sources. The New Zealand information is based on a survey of the five main trading banks (ANZ-National, ASB, BNZ and Westpac). Australian information is based on consensus forecasts compiled by the UK Economist. Sources of other information are as shown. Where appropriate, averages are included alongside the highest and the lowest forecasts, giving an idea of the spread of forecasts and therefore of the uncertainty involved. The information in this report is of a general nature; your firm is unique, and you will need to make your own decisions. However, the better informed you are about the way various business people see the future, the better the decisions you can make.

HIGHLIGHTS

Inflationary pressures will be around for some time to come, despite a weakening housing market.

Interest rates in NZ will remain high as the Reserve Bank attempts to contain inflation. The significant discrepancy between interest rates in NZ and the rest of the developed world will continue to put upward pressure on the NZ dollar.

World commodity prices have recently peaked but NZ exporters have not benefited as much as they should have from strong commodity price growth over the last 2-3 years because of the persistently high NZ dollar.

Net migration numbers continue to ease, which is a two-edged sword for the Reserve Bank in ensuring price stability is achieved. While it takes further pressure off the housing market (which looks set for a fall), it is constraining an already overheated labour market thus putting strong upward pressure on wages.

Part 1: The New Zealand Economy

1.1. Economic growth (GDP) – modest growth expected

Most recent outcome: 2.7% for the year to September 2007.

Gross Domestic Product (GDP) is a measure of a country's total economic activity over a given period. Since 2000 New Zealand's annual GDP growth has averaged over 3%, indicating a relatively strongly performing economy with higher growth than in many other developed countries. However, growth prospects have taken a hit on the back of a slowing international economy, with expectations for growth dropping in 2008/09, as indicated below.

While NZ is while capable of weathering the continuing fall-out associated with sub-prime mortgages in the US and the likelihood of a US recession given the continued strong growth in Asian economies, there are clearly some constraints on NZ growth prospects. A tight labour market and a continued slow-down in net migration are putting significant pressure on available resources, while businesses are generally operating at very close to full capacity. Combined with the continuing higher dollar, underpinned to some extent by higher interest rates, the effect will be to constrain returns to NZ exporters.

Quarterly results show economic activity expanded by 0.5% in the September 2007 quarter (the latest available data), marginally higher than market expectations. Along with a small upward revision for the previous quarter (revised upwards from 0.7 to 0.8) this took annual average growth to 2.7% (up from 2.1% in June 2007).

Activity in the mining industry was strong, largely due to production from the Tui oil field coming on line, as well as to increased exploration activity. Some economists estimate that "Tui" was probably responsible for around 0.2 percentage points or around one-half of the growth experienced in the September 2007 quarter.

The services industry again made a large contribution to growth (up 0.7%), with the Finance, Insurance and Business Services industry contribution (up 0.8%) also significant. Stronger mining activity saw primary industries increase 3.9%, while weaker manufacturing production (down 2.2%) saw the goods-producing industries fall 1.4%.

Despite the relatively mediocre growth result for the September 2007 quarter, growth for the December 2007 quarter and March 2008 quarter is likely to be relatively strong on the back of significantly higher exports and returns for dairy.

The trade balance for December 2007 was a small surplus of $33 million, only the second December surplus in the past decade and encouraging given that the month of December is normally in deficit. For the December 2007 year the trade balance was a deficit of $5.3 billion, the smallest annual deficit since June 2005.

Merchandise exports for the December 2007 quarter were up 20.8% on the September 2007 quarter, the largest increase on record, reaching a new high.

Milk powder, butter and cheese (up $767 million to a record level) contributed most to the exports increase, while a recent growth increase in crude oil exports also contributed to the large increase over the last quarter of 2007.

At the same time, imports increased 11.3% and also reached a new high. However, import growth is likely to slow on the back of a slowing housing market and consumer spending starting to moderate.

Expectations are that GDP will slow initially over the forecast period, as shown in the table below, and then improve further out. However, growth levels of 2-3% are still below those of our major trading partners and well below those needed to propel New Zealand back into the top half of the OECD.

Forecasts: Real GDP % Growth

	Years Ending		
	Mar 08	Mar 09	Mar 10
Highest	3.2	2.8	3.2
Average	3.0	1.9	2.6
Lowest	2.8	1.1	2.0

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

Business NZ believes key factors influencing GDP over the next two years will include:

Interest rates – remaining high with an outside chance of further hikes

New Zealand's Official Cash Rate (OCR) is still very high by international standards, and is expected to remain at current levels for some time, given continuing inflationary pressures in the economy. In tandem with continued inflationary pressures, New Zealanders' strong tendency to fund consumption out of debt also puts upward pressure on interest rates as international financiers want a reasonable return on their funds to compensate for the perceived increased risk of investing in New Zealand.

The extent of NZ's external imbalance leaves the country vulnerable as international investors are re-pricing risk and credit is becoming internationally more expensive in light of recent events. NZ's large external deficit leaves it susceptible to a change in investor sentiment since the country relies heavily on external funding for its investment needs.

Since the previous Business Planning Forecast, the USA Federal Reserve has slashed interest rates a number of times in reaction to a slowing economy in the near term, reflecting the intensification of the housing correction and reduced consumer confidence. The upshot is that New Zealand interest rates now look much more attractive to investors, as one of our competitors for funds investment falls back. On the flip side, ongoing inflationary concerns in Australia due to increasing demand and output growth have seen the Australian Reserve Bank lift interest rates again, reducing the differential between Australia and New Zealand to 1.25 percentage points.

In New Zealand, the Reserve Bank believes that core inflationary pressures persist despite the housing market slowing significantly. The labour market is still overheated with reducing net migration and capacity constraints putting upward pressure on wages. Consumer spending, while moderating of late, is still moving along at a fairly brisk pace. In addition, the Bank is concerned that fiscal policy is contributing to inflationary pressure, with any easing beyond that already announced adding further upside risks. *"Ongoing inflationary pressures are underpinned by an expansionary fiscal policy and rising food and energy prices, which will be under further pressure with the Emissions Trading Scheme in a year's time."*

While the Reserve Bank predicts inflation to remain above 3% during 2008, they believe that the current level of the OCR remains consistent with future inflation outcomes of 1 and 3% on average over the medium term. This is likely to be code for interest rates staying higher for a longer period of time, although further rises in interest rates are unlikely despite a number of commentators predicting further rises in the OCR later this year.

Official Interest rates

Central Bank	Current rate (%)	Previous rate (%)
Reserve Bank of Australia	7.00%	6.75%
US Federal Reserve	3.00%	3.50%
Bank of England	5.25%	5.50%
European Central Bank	4.00%	3.70%
Reserve Bank of NZ	8.25%	8.00%

Looking forward, the general consensus is that New Zealand's OCR has reached its peak but that the rate will not fall until early 2009 at the earliest. However, further rises in the OCR between now and then cannot be discounted as a few have predicted, given the continued tight labour market, with unemployment at record lows and wages inflation continuing to push upwards.

The New Zealand Dollar – anyone for a random guess?

Anyone is in the profession of short term currency trading is either making or losing a fortune given how volatile the NZ dollar has been over recent months.

Since the last Business Planning Forecast, the New Zealand dollar has bounced around on a daily basis like a yo-yo but overall has generally remained within the 70-72 cent mark on a Trade-weighted Index (TWI) basis – until recently. Market sentiment until a couple of months ago was for the NZ dollar to decline against the US (and indeed this started to happen early in January 2008 as markets moved away from higher yielding currencies to more stable currencies). However, in light of the dramatic collapse in the US interest rate since, confidence has been restored in high yielding markets like NZ. The returns appear to be attracting investors despite the risks involved. One possible reason for the reigniting of interest in NZ is that given relatively high inflationary pressures, there is little or no possibility of early interest rate cuts, thereby partially insulating investors from the possibility of a significant and rapid fall in the NZ dollar. While the dollar is driven by a number of factors, interest rates can, but do not always, have a significant bearing on its value particularly with the wide discrepancy between interest rates in NZ and the rest of the world, with the possible exception of Australia.

Given the above factors it is perhaps not surprising that there are big differences between forecasters on the potential movements of the TWI going forward. For example, in March 2009 some forecasters are predicting a TWI of 71.0 while at the other extreme others are predicting a TWI of 62.5. The reality is that it is very much a random walk at present, although expectations are for the NZ dollar to decline substantially in the future. The question is when?

Net migration flows – continuing to slow

Over the last few years relatively large migration inflows, on average, have boosted domestic consumer spending, car sales and house building. Migration has also helped mitigate some of the pressures building up in the labour market. This has now changed.

The annual net migration gain peaked at +42,500 for the year ended June 2003, fell as low as a +6,000 gain for the year ended October 2005 and then regained some momentum in 2006 to reach an annual gain of 14,800 by November 2006. However, since early last year net migration figures have drifted downwards (to 5,500 for the year ending December 2007), with slowing net migration largely due to a rise in the number of permanent and long-term departures, particularly to Australia. In the year ended December 2007 there was a net outflow of 28,600 to Australia compared to 20,700 the previous year. This takes the net outflow to Australia to its highest level for a December year since 1988 (when it was 33,400).

The continued reduction in the net inflow of migrants is having a two-fold effect. On the positive side, it continues to take pressure off housing demand which will be welcomed by the Reserve Bank. On the other hand, it means less skill capacity in New Zealand

and upward pressure on wages, given limited flexibility to provide more labour.

Commodity prices – coming off a high

After peaking in November 2007, the ANZ Commodity Price Index fell 1.4% in January 2008 – the first drop in the index since June 2006. The strength of international dairy prices over the last couple of years has largely underpinned the significant rise in the ANZ World Commodity Price Index over the same period, although the index is expected to decline further over coming months in light of increased international uncertainty and reduced growth prospects. However, it is important to realise that the commodity boom was destined to peak at some stage following the huge and unsustained rises experienced over the last couple of years.

To put the latest commodity cycle in context, the current cyclical peak was 37% higher than the previous cyclical peak.

The ANZ Commodity Price Index stood at 211.7 for January 200*, down 1.4% on December 2007 but up 27.4% on the same time the previous year.

When converted into NZ dollars, the ANZ NZ Dollar Commodity Price Index actually went down slightly in the month of December 2007 (down -0.9%) and also in January 2008 (down 1.8%). This largely reflects the impact of a generally rising $NZ against our major trading partners of late (particularly against the US and to some extent Australia). On an annual basis commodity prices, when converted into $NZ, were up 15.9%.

While NZ dairy farmers are now reaping the rewards of higher international prices in respect to milk pay-outs, the continued drought in some parts of the country may well see overall returns not as favourable as first expected given continued downward pressure on production as a result of feed shortages and reductions and constraints on use of irrigation in some parts of the country.

	World Price Index	Monthly % Change	Annual % Change	NZ$ Index	Monthly % Change	Annual % Change
January 2003	120.2	1.1	4.4	116.1	-3.9	-15.5
January 2004	133.3	2.3	10.9	107.4	-0.7	-7.5
January 2005	153.1	0.7	14.9	117.1	1.8	9.0
January 2006	149.6	-0.2	-2.3	115.6	1.4	-1.3
January 2007	166.2	1.3	11.1	129.7	0.8	12.2
January 2008	211.7	-1.4	27.4	150.3	-1.8	15.9

Source: ANZ Commodity Price Index NZ – 5 February 2008

Business confidence – drifting down

Both business and consumer confidence surveys tend to show confidence is drifting lower, although the results need to be read with a grain of salt.

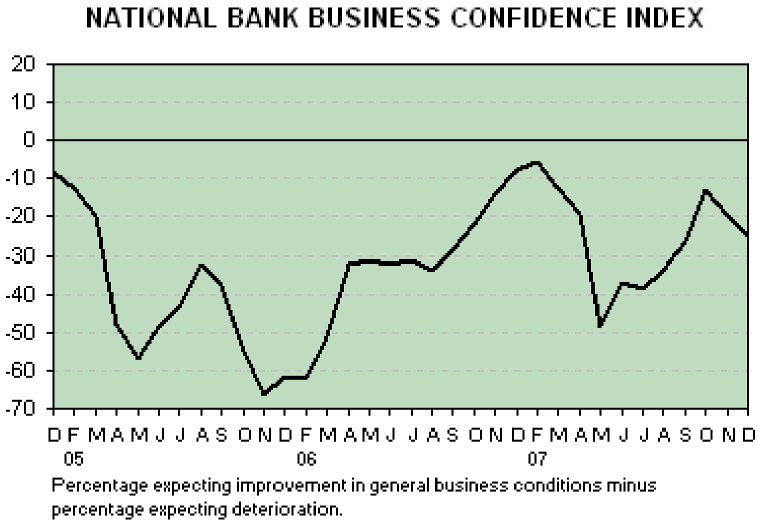
On the upside, the general view from individual businesses is that the economy will perform at lower levels than currently, but that personally they are generally doing okay. This may reflect a general grumpiness with the government over a range of issues rather than factors directly impacting on their business operations per se. On the other hand, the risk is for a further deterioration in business confidence if interest and the exchange rates stay higher for longer, while dropping commodity prices will be reflected in lower returns to producers.

The National Bank's Business Confidence Index shows that although business confidence fell further in December 2007, it was more of a downwards drift rather than a sharp drop. The December survey found that a net 25% of respondents expect business conditions to deteriorate over the coming year, compared to a net 20% in November.

Confidence drifted lower in the retail, construction and service industries, while improving slightly for both the agricultural and manufacturing sectors.

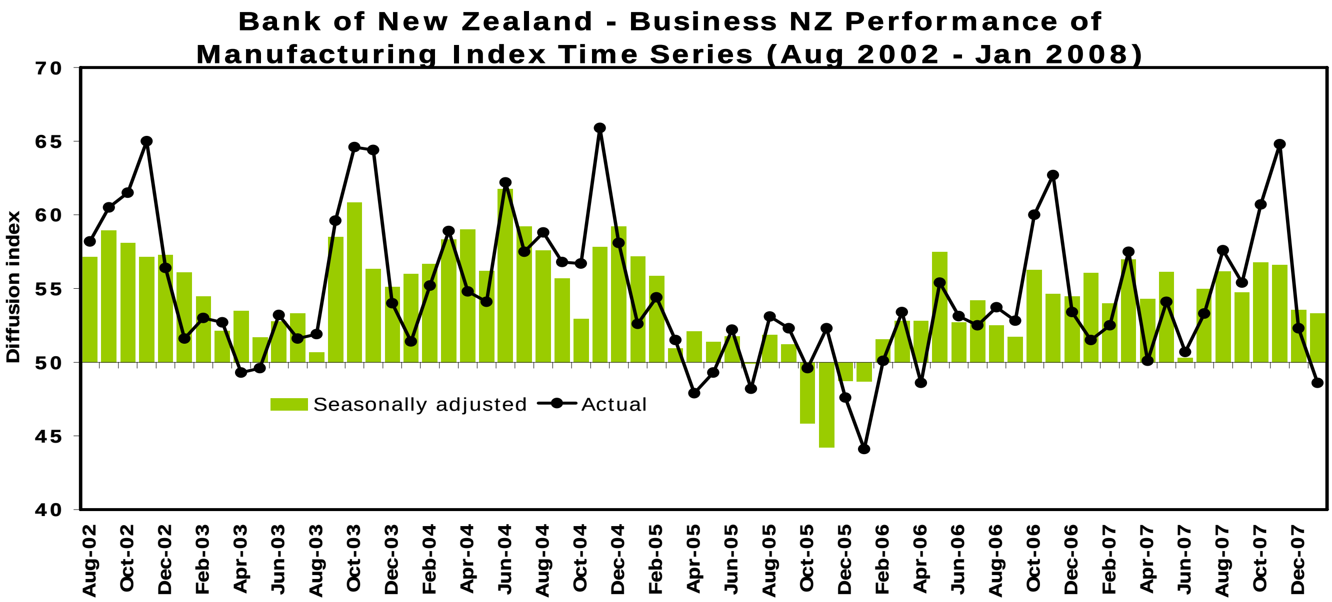
Firms' own activity expectations have increased slightly, with a net 18% expecting better times for their own business over the coming year, up from 16% in November 2007.

While individual firm confidence appears relatively robust, there are potential risks moving forward. The international repricing of credit risk, reduced wealth gains from assets, and higher interest rates with implications for the currency are now combining to add a degree of doubt to future prospects which was not there in the last quarter.



A drift downwards in business confidence is indicated by the recent results of the Bank of New Zealand - Business NZ Performance of Manufacturing Index (PMI) and Performance of Service Index (PSI). While the last few months indicated a pick up in manufacturing activity, the graph below shows a sharp fall into negative territory for the unadjusted series, the first sub-50 value since April 2006. The seasonally adjusted result still shows expansion but the next few months may see expansion easing further.

Although the PSI is still a relatively new survey, and as yet not able to provide exact year on year comparisons (nor seasonally adjusted results), activity in the services sector continued to ease for the start of 2008. With the majority of service sector businesses saying that on balance activity was lower than at the same time last year, a general softening in activity seems the most likely candidate for change in 2008.



Consumer confidence – rising costs and debt servicing hitting consumers

Westpac's Index of consumer confidence dropped 3.5 percentage points in the December quarter 2007 to sit at 110.0 – which is still relatively robust. An index number over 100 indicates there are more optimists than pessimists, while a number below 100 indicates that pessimists outnumber optimists.

While job security is reasonably good and income growth has been strong, this has been offset to some degree by the three significant but basic elements of living – food, housing costs (mainly debt servicing) and transport. All three have been on the rise over recent times, putting a strain on many household budgets burdened through high levels of debts and the slow creep upwards in interest rates as lower fixed rate mortgages come up for renewal.

Consumer confidence is expected to take a further hit as the perceived wealth effect from a rapidly rising housing market over the last five years peters out. In fact, there are a number of indicators which would suggest that the housing market is in for a substantial correction over the next couple of years for a number of reasons, including:

- High levels of debt and the prospect of interest rates staying higher for longer which will put some households under pressure to "downsize"

- The 4th Annual Demographia Housing Affordability Survey (January 2008) which shows that NZ has one of the least affordable hosing markets compared to a number of other countries surveyed. *"New Zealand (with Australia) has the least affordable housing among all the surveyed nations. The national Median Multiple is 6.3, more than double the Median Multiple ceiling of 3.0. New Zealand is the only surveyed nation in which all of its markets are rated "severely unaffordable." Tauranga is the least affordable, with a Median Multiple of 7.5. Auckland has a Median Multiple of 6.9"*
- Significant reductions in net migration reducing demand for new and existing housing stocks.
- The significant and continuing decline in the number of houses being bought and sold and the marked increases over the last 3-4 months in the average number of days taken to sell, both telltale signs of a general softening in prices going forward.

A very strong labour market has underpinned the housing market to date but any softening will likely have an adverse effect given the substantial drops in average house prices (and sales) over the past 3-4 months.

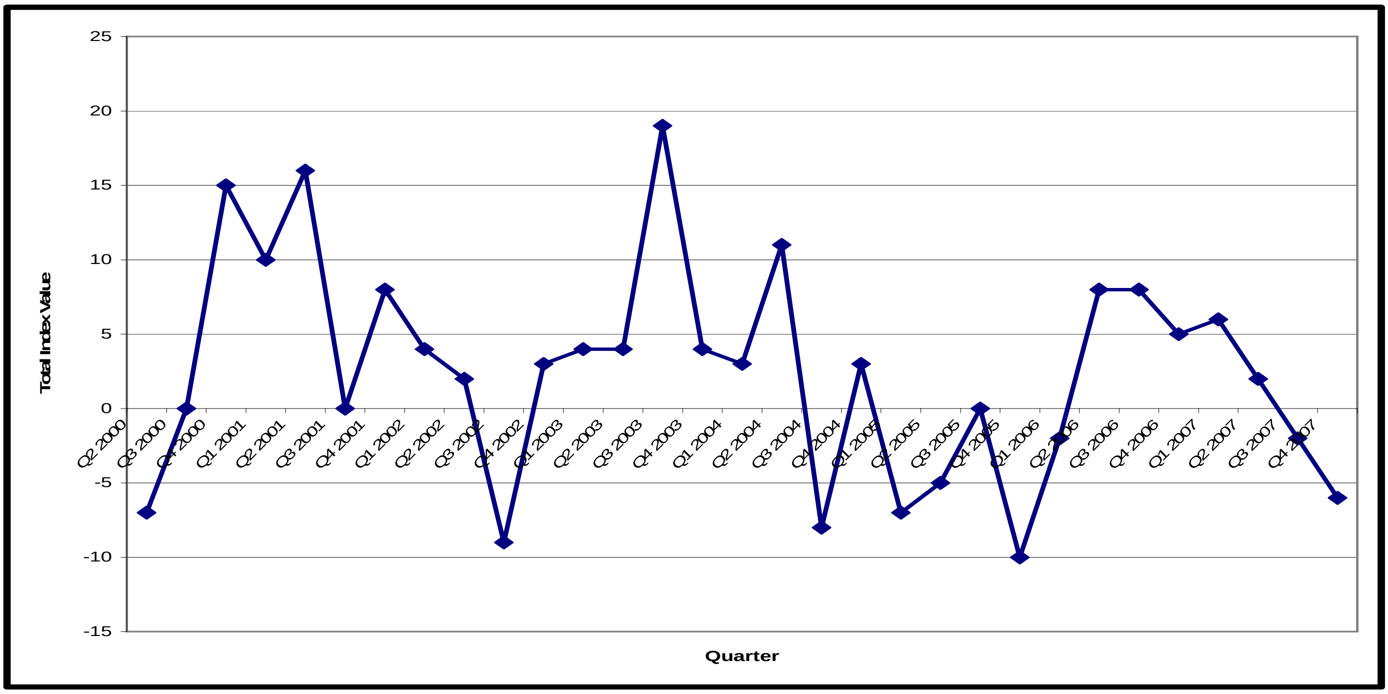
Despite the likelihood of increasingly negative consumer confidence going forward, consumer confidence is likely to have a shot in the arm when the Government announces the nature of its personal tax reduction package in the May Budget. While the Government has effectively committed $1.5 billion for the proposed tax cuts, the nature of the package is still uncertain. With global uncertainties and significant inflationary pressures still evident in the economy, the Minister of Finance could delay the implementation of the package. However, this scenario is likely to be overruled by politics given the general election is coming up later this year. Any further delay in providing cuts to personal taxation would be seen very cynically by the public who have already waited a considerable time for tax relief.

Putting it all together – drifting along slowly

The graph below shows the trend of the main economic factors that are converted into an overall index, taking into account economic growth/performance indicators, monetary policy/pricing indicators, business/consumer confidence indicators and labour market indicators. The overall Business NZ Economic Conditions Index sits at -6, down 4 on the previous quarter and down 11 on a year ago. It is currently at its lowest level since December 2005.

The continued drop in the index over recent quarters has been driven by a number of factors which are affecting both business and consumer confidence. Lower international growth prospects on the back of global financial jitters are impacting on the NZ economy while inflationary pressures are likely to persist, thus putting upward pressure on the NZ dollar as interest rates remain higher for longer. On the other hand, continued buoyancy in international commodity prices (despite a reduction of late) will assist in improving NZ's current account balance, although high levels of overseas debt will limit progress in this area. A healthy labour market and tax cuts to be announced in the upcoming Budget will offset some of the added costs facing households as a result of higher debt servicing costs, rising fuel prices, increased food costs and the flow-on effects of the Government's proposed emissions trading scheme.

Business NZ Overall Economic Conditions Index



1.2 Inflation – strong pressures persist

Most recent outcome: +3.2% year-ended December 2007

The rate of inflation as measured by the Consumer Price Index (CPI) indicates increases in price levels and provides an indirect benchmark for wage demands. It is also the key reference point for monetary policy.

The December quarter 2007 CPI rose 1.2% on the September quarter, bringing headline annual inflation to 3.2% - outside the Reserve Bank's target range of 1-3%. The Reserve Bank is picking inflationary pressures to remain strong with headline inflation expected to remain above 3% for 2008.

The main driver of the increases for the December quarter was the transport group (up 3.2%), underpinned by higher oil prices.

The increase in the transport group was mainly due to price increases for petrol (up 5.4%) and international air transport (up 11.9%). If petrol prices had remained constant over the same period, the CPI would have risen 1.0%. Prices for domestic air transport made a downward contribution for the transport group, falling 4.5% for the quarter. This would likely have been driven by greater competition on a number of the main routes as carriers introduce bargain basement prices in an attempt to buy increased market share.

An increase for the food group (up 1.5%) also made a significant contribution in the December 2007 quarter, with higher prices in the grocery food subgroup (up 3.4%) being the most significant contributor. The increase in the grocery food subgroup was mainly driven by higher prices for cheese, butter and fresh milk.

Prices for the housing and household utilities group rose 0.9 percent in the December 2007 quarter. These were pushed up mainly by higher prices for the purchase of new housing (up 1.3 percent), electricity (up 1.2 percent) and housing rentals (up 0.5 percent). Further upward pressure is likely on rental housing as landlords seek to get a reasonable return on their investment. On the other hand, reduced net migration, and a surplus of housing in some areas might see rental prices stabilising.

In the December 2007 quarter, the non-tradable component of the CPI increased 0.7 per cent, following an increase of 0.6 per cent in the September 2007 quarter. The tradable component increased a massive 1.8 per cent in the September 2007 quarter, following an increase of 0.5 per cent in the June quarter 2007. The tradable component would have risen 1.2 per cent if petrol prices had remained constant over the same period.

From the December 2006 quarter to the December 2007 quarter, the non-tradable component increased 3.5 percent and the tradable component rose 2.8 per cent. If petrol prices had remained constant over the same period, the tradable component would have increased only 1.1 per cent. This shows that the Reserve Bank must be mindful of the impact of factors beyond its control (or indeed the control of businesses or consumers) when setting monetary policy.

Notwithstanding short-term variations in the CPI components, the continued strength of non-tradables inflation reinforces the need to ensure that the economy is as competitive as possible by removing the monopoly provision of some goods and services, currently provided by the Government or its various agencies.

Inflation data relating to producers' input and output prices rose more than expected in the December quarter, largely led by the dairy surge. Although the correlation between the PPI and CPI is contemporaneous at best, it will mean the Reserve Bank continues its current stance of extra vigilance about inflationary pressures as upside risks continue. However, in spite of the slowing housing market, it would probably take a significant trigger for the Reserve Bank to resume any tightening of monetary policy.

Forecasts below show inflation likely to remain around the very top end of the inflationary band, obviously leaving almost no leeway for any shocks. Therefore, there is every chance forecasts could be revised upwards, although slowing domestic activity may take some pressure off, counteracting any upside shocks.

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Mar 08	Mar 09	Mar 10
Highest	3.8	3.3	3.3
Average	3.5	3.1	3.0
Lowest	3.3	2.9	2.7

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

1.3 Labour costs – wage pressures to remain in the medium term

Most recent outcome: +3.4% -- year-ended December 2007

As to be expected in a tight labour market, continued wage pressures are causing skill shortages in a number of industries and regions, pushing up average labour costs as a result. To a certain extent these costs are flowing through into general wage pressures across the economy as a whole.

The Labour Cost Index (LCI) recorded an increase of 3.4% in salary and wage rates (including overtime in the year to the December 2007 quarter. This is the highest annual increase since the series began in the December 1992 quarter. Salary and wage rates, recorded an increase of 3.4% and 3.1% for the private and public sectors, respectively.

An alternative measure of labour costs is the Quarterly Employment Survey (QES). This tends to be much more volatile than the Labour Cost Index, mainly because it reflects compositional changes in the labour force. As with the LCI, the QES also shows significant wage and salary pressures across the board with a quarterly rise of 0.9% and an annual rise of 4.0% for the year to December 2007.

Forecasts below continue to show stronger wage inflation in the short-medium term, although with the possibility of some pressure easing by 2009. However, with historically low unemployment, and businesses sometimes having trouble getting anybody on the factory floor, the prospect of further wage pressures will continue to loom for some time to come. A slowdown in net migration is fuelling the current labour shortage.

Forecasts: Labour Cost Index % Change

	Years Ending		
	Mar 08	Mar 09	Mar 10
Highest	3.4	3.1	2.9
Average	3.3	3.0	2.7
Lowest	3.1	2.7	2.4

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

1.4 Employment – still growing strongly but lack of people will slow growth

Most recent outcome: 2.5% -- year-ended December 2007

The labour market continues to perform strongly, with strong employment growth recorded for the December 2007 quarter after the slight reduction recorded in the September quarter 2007.

The strength of employment growth in the December 2007 quarter was driven entirely by the 1.6% increase in full-time employment, with part-time employment falling 0.2% over the quarter. Female employment growth was particularly strong for the quarter (up 2.6%) compared with a slight fall of 0.2% in male employment. Annual employment growth is now running at 2.5% but with labour force participation rates at a new peak, and net migration drying up, constraints on further growth are now evident.

The extremely tight labour market is resulting in a significant rise in both female employment, and also growth in the entry of older workers into the workforce. For example, annual employment growth for workers aged over 60 years was 10% last year. This has implications for employment recruitment techniques and also means perhaps greater pressures on employers as they cope with the implications of employing a much more diverse workforce than has traditionally been the case. Obviously flexibility in hours worked will be only one of the many issues which needs to be considered in this context.

One has to ask how low the unemployment rate can get now that it sits at 3.4%. Forecasts below show it heading up rather than further down, although even by 2009, an unemployment rate of 4% would still mean the likelihood of ongoing wage inflation pressures.

Forecasts: Unemployment % (HLFS)

	Years Ending		
	Mar 08	Mar 09	Mar 10
Highest	3.9	4.4	4.4
Average	3.7	4.0	3.9
Lowest	3.3	3.2	2.8

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

1.5 Interest Rates (90-day bill rate) – steady but no reductions in the near term

Most recent outcome: 8.82% as at 14 February, 2008

Overdraft and mortgage interest rates generally move in line with the 90-day bill rate, which is in turn heavily influenced by the Reserve Bank's OCR (although they may be at variance if the market prices in future increases or decreases in the OCR).

The impact of higher interest rates on households is now showing signs of being significant, with floating rates at around 10.5%, and short term fixed rates around 9.5%. Given the increase in official interest rates is (probably) at its peak, there is no real justification for people to enter into longer term mortgage rates, and the 1 or 2 year options are the most popular. Still, at that level with total household debt continuing to rise, hefty mortgage repayments will over the next few years for many consumers leave little room for consumption elsewhere

The extremely strong labour market, with continuing wage pressures evident will see the Reserve Bank loath to reduce interest rates for fear of refuelling the housing market. Having been burnt before, the Reserve Bank will likely ensure that inflationary pressures are well and truly squeezed out of the economy before announcing interest rate reductions. This means that high interest rates are here to stay for a significant period of time unless the wheels start falling off the economy – and there is certainly no evidence of that despite a likely plunge in house prices over the next few months.

The forecasts below point to reductions in interest rates by 2009, although this is not a foregone conclusion. There is still the possibility of interest rates remaining high for some time.

Forecasts: Interest Rates (90 day bills)

	As at End of		
	Mar 08	Mar 09	Mar 10
Highest	8.8	8.9	8.0
Average	8.7	8.0	7.1
Lowest	8.7	7.0	6.3

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

1.6 Exchange Rates – currently like a yo-yo

Most recent outcome: *NZD = US$0.797 as at 21 February 2008*
NZD = AU$0.867 as at 21 February 2008
TWI = 73.0 as at 21 February 2008

The TWI still lies above the 72-mark, while the NZ$ against the US$ continues to show large variations almost on a daily basis.

The NZ dollar continues to be overvalued with some commentators suggesting it is around 10-20% above its long-term trend.

Underpinned to some extent by continued high interest rates in NZ compared to our major trading partners, the rise in the NZ dollar against the US in part reflects the general weakness of the Greenback over recent times. For similar reasons, the NZ dollar is even stronger against the globally shunned Japanese yen. In contrast, the NZ dollar is clearly not above the long-term norms of the Aussie or Euro.

The closure of a number of high profile manufacturers and decisions to manufacture off-shore are testament to the dollar's impact on some in that sector. However, many of these moves are likely to have occurred irrespective of where the dollar is at, in that they reflect more fundamental structural changes as producers try and locate production closer to their main markets.

Many manufacturers appear to be handling fluctuations in the NZ dollar better than in the past, through a combination of good hedging policies, better analysis of markets and market opportunities, and improved control of production costs through manufacturing both on and off-shore, as appropriate.

Market expectations are for the NZ dollar to struggle against the currencies of our major trading partners over the next year or two. However, this will very much depend on NZ economic growth and, particularly inflation – the factor that has resulted in significantly higher interest rates in NZ and the rest of the world, and to some extent has underpinned the NZ dollar.

The current uncertainty surrounding global growth prospects and their implications for NZ is reflected in the wide-range of forecasts for the NZ dollar over the next couple of years. While expectations are for a significant drop over time, when and by how much are certainly the subject of much debate. Clearly with changing global circumstances, forecasting exchange rates is fraught with difficultly.

AUD (cents)			
	Mar 08	Mar 09	Mar 10
Highest	0.874	0.835	0.870
Average	0.853	0.815	0.825
Lowest	0.835	0.786	0.789

USD (cents)			
	Mar 08	Mar 09	Mar 10
Highest	0.790	0.760	0.720
Average	0.768	0.700	0.653
Lowest	0.760	0.660	0.600

TWI			
	Mar 08	Mar 09	Mar 10
Highest	71.7	71.0	69.1
Average	70.7	66.9	64.8
Lowest	69.7	62.5	60.9

Part 2: The Australian Economy

Monitoring the performance of the Australian economy is critical in the first instance because Australia's performance provides a measure of how well New Zealand exporters are likely to fare: a stronger Australian economy will generally 'suck in' imports. Monitoring also provides an indication of the likely strength of competition from Australian sourced products on the domestic market.

The Australian economy continues to hum along. Despite a change of Government at the recent Federal elections, it is largely business as usual. Further rounds of tax cuts may provide more incentives for New Zealanders to head across the ditch although at current levels (net outflow of around 28,000 from NZ to Australia per annum), it is hard to see these figures rising.

While parts of Australia are still suffering from drought (while other areas have recently been flooded), general commodity prices have remained high and the minerals boom continues to provide strong employment and economic growth.

Australia, like NZ, is suffering a bit of an inflationary problem, which is reflected in the RBA recently raising interest rates. Unlike NZ where many households are on fixed rate mortgages, Australians tend to go with the floating rate so any interest rate changes are moreorless immediately reflected in higher mortgage rates. This is likely to put a bit of a dampener on consumer confidence going forward, particularly if the RBA decides to raise rates even further, which is likely.

2.1 Economic Growth (GDP)

Most recent outcome: +4.3% for the year-ended Sept 2007.

Forecast 2008: +3.5
Source: *The Economist*

Australia's annual GDP increased to a healthy 4.3% in the September 2007 quarter. However, forecasts point to an easing of growth to around 3.5% by 2008/09.

Some key recent economic statistics:

- Real retail sales up 7.9% in December 2007 compared with December 2006.
- New motor vehicle sales up 8.3% for December 2007 compared with December 2006.
- Dwelling unit approvals up 6.9% for December 2007 compared to December 2006.
- Employment up 2.6% for January 2008 compared to January 2007.
- Unemployment rate of 4.3% as at January 2008 – down from 4.6% in January 2007.
- Participation rate of 65.2% as at January 2008 – up from 64.8% in January 2007.

The latest Australian PMI results (January 2008) show that Australian manufacturing went into decline (49.2) after 19 consecutive months of growth, reflecting the impact of global market turbulence on manufacturers' confidence, concerns about rising input costs and interest rates, along with seasonal factors. Regarding the service sector, the Australian PSI stands at 54.9 (seasonally adjusted), although the rate of growth moderated with companies citing weaker consumer confidence.

2.2 Headline Inflation

Most recent outcome: +3.0% for the year-ended December 2007

Forecasts: Mid 2008: 3.1%
Source: *The Economist*

After holding interest rates at 5.25% for a long period, the Reserve Bank of Australia has lifted the cash rate a number of times to now sit at 7.0% (1.25 percentage differential with NZ) with further rises likely.

Inflationary pressures remain strong with the Reserve Bank of Australia being unusually explicit in their latest quarterly Statement of Monetary Policy where they see a probable need to raise interest rates again following the latest increase of 0.25%. The RBA considers that the domestic economy is still overheating and that inflation is going to remain outside the target band for the next couple of years. They predict underlying inflation this year at 3.75%.

Given the average Australian householder's exposure to floating interest rates for their mortgage as stated above, there may well be a reduction in consumption as household budgets are squeezed. Nevertheless, like New Zealand, employment growth is still strong with record low unemployment, factors likely to fuel continued domestic consumption for some time.

Part 3: Rest of the World

The economic picture for the rest of the world is very important for New Zealand. Lower international growth prospects on the back of global financial jitters will impact on the NZ economy although the downturn (not yet recession) in the US, while affecting NZ, may not be too significant.

Despite international concern about a potential US recession, any adverse impact on NZ would likely be less than in the past. The old saying that when the US sneezes, the rest of the world catches a cold is no longer valid.

Economic growth is now increasingly fuelled by the fast-growing Asian economies. While world growth is projected to decline in the light of recent financial market turmoil and a mark-down of stock markets around the world, the new power houses are Asian centred. China's growth rate is currently sitting at over 11 percent per annum (its highest growth rate since 1994), with expectations for growth to continue at close to 10%.

In 2005, the US economy accounted for around 23% of the world economy compared to around 10% for China and 7% for Japan. Despite the above, US purchases of foreign products are not the driving force they once were behind world economic growth. US imports of goods as a share of world imports peaked at 18.7% in 2000. In 2006, the US market accounted for only 15.5% of such trade.

United States

Whether the US goes into a recession (defined as two negative quarters of GDP growth) is a moot point. The big question will be how American consumers react in light of significant declines in housing prices and the impact this has on their spending patterns. Already employment is starting to fall although consumer spending, while flat, has certainly not followed suit.

The Federal Reserve's aggressive recent cuts to interest rates and a recently agreed major fiscal package will likely restore some confidence in markets and particularly in consumers. These moves appear to have had a positive impact so far by boosting confidence and risk appetites. This has not necessarily been good for NZ having brought about a renewed interest in countries with high yielding interest rates such as NZ, and to an increasing extent, Australia.

The Federal Reserve's Chairman (Bernanke) has indicated that he expects the economy to avoid a recession but grow very slowly in the first half of this year, followed by a somewhat stronger pace of growth starting later this year as the effect of the monetary and fiscal stimulus begin to be felt. While there is a chance of further rate cuts, "unscheduled cuts" are very unlikely at this stage.

Euro

Euro GDP growth of 0.8% in the third quarter of 2007 boosted annual growth from 2.5% to 2.7%.

More recent data (based on business surveys and industrial production) point to significantly weaker growth which will dampen inflationary pressures resulting in a likely drop in Euro interest rates going forward. While the European Central Bank (ECB) has recently left their interest rate unchanged at 4%, the ECB President did imply that an interest rate cut was likely. *"While the economic fundamentals are sound, incoming data have confirmed that the risks surrounding the outlook for economic activity lie on the downside."* Markets have read this as code for interest rate cuts soon. Despite the potential for interest rate cuts, inflationary pressures are still evident with the inflationary rate currently running at 3.2%, well above the 2% targeted by the ECB. Obviously at the back of the Central Bank's mind will be the potential global inflationary problems associated with rising food prices and energy prices.

Despite recent growth, unemployment remains doggedly high in Europe with little relief in sight. Unemployment is forecast to remain above 7% for 2008 and in fact to increase to 7.7% by 2009.

Inflationary pressures are likely to abate although current forecasts expect inflation to remain around the 2-3% level out to 2009.

Japan

In Japan, growth rates continue to be mediocre with forecasts of 1-2% expected for the current year and 2009.

Consumer prices remain very subdued, evidenced by very low interest rates in Japan (currently 0.5%). While there has been some talk of an interest rate cut, there is concern that inflation might be boosted by higher oil prices. Nevertheless, an interest rate cut would unlikely boost confidence given that inflation is already close to zero anyway.

Despite relatively low growth in Japan over recent years, unemployment is expected to remain low, around 4% per annum.

Weak data on confidence has resulted in the depreciation of the yen against a number of currencies, including the NZ dollar.

Forecasts: World GDP Growth (Selected Trading Partners)

Country	*Latest*	*2008*	*2009*
Australia	4.1	3.5	3.3
Canada	2.9	1.7	2.4
Japan	1.5	1.3	1.8
United Kingdom	2.4	1.7	2.1
United States	0.6	1.6	2.5
Euro Area	2.8	1.8	1.9

Source: Economist

Forecasts: World Consumer Price Inflation (Selected Trading Partners)

Country	*2008*	*2009*
Australia	3.2	2.7
Canada	2.1	2.0
Japan	2.3	2.0
United Kingdom	2.1	2.0
United States	2.8	2.2
Euro Area	2.3	2.0

Source: Economist