

## Economic outlook improving...slowly

### Executive Summary

After significant turmoil in the last quarter of 2011 and the beginning of 2012, the outlook for the global economy has stabilised somewhat, although risks remain, particularly around unsustainable debt levels in a number of developed countries.

While financial bailouts may have kept international financiers happy for the moment, more difficult structural reforms are required in a number of countries before markets will have confidence to invest.

From New Zealand's perspective, continued relatively strong growth in our major trading partners (despite a dip in growth projections for China) will ensure that commodity prices remain solid notwithstanding continuing slippage of late. Recent solid economic data coming out of the US is also a positive for future world growth prospects.

On the domestic front, businesses and households continue to focus strongly on retiring debt, not necessarily a bad thing although it does have implications for particular sectors, including retail, tourism and the service sector in general.

Excellent growing conditions and strong production within the agricultural sector generally have meant that export volumes remain high, while returns to producers continue to be positive, as evidenced by a number of surveys.

Business confidence has improved of late after taking a dip on the back of global uncertainty at the latter end of 2011, boding well for future economic growth. However, such results need to be taken with a large grain of salt since expectations and reality can differ significantly given the volatility experienced in international markets since late 2008.

On the political front, the Government has started its second term with a renewed sense of urgency, which is positive. Reforms over a number of fronts are underway with the Government's clear focus on creating a more competitive economy. Business will be keen to ensure that much-needed reforms actually materialise. Actions over a range of areas are required – not just by government but by businesses and households as well. No one factor on its own will significantly improve New Zealand's competitiveness. For example, macroeconomic stability may be necessary for generating sustainable economic growth but is not sufficient on its own. It is simply a platform on which to make sound investment decisions.

### HIGHLIGHTS

The BusinessNZ Economic Conditions Index (ECI) sits at 6 for the March 2012 quarter, up 9 from the previous quarter and down 1 on a year ago.

Global markets have settled somewhat after the significant volatility experienced in the last quarter of 2011. Nonetheless, uncertainty remains as a number of countries continue to grapple with unsustainable levels of debt.

International commodity prices continue to ease although they remain relatively high by recent historical standards, boding well for NZ exporters and the rural sector in particular.

Business and consumer confidence continues to wax and wane on a monthly basis in response to international uncertainty but more latterly is showing signs of improvement.

Households and businesses are continuing to take a cautious approach to new investment with debt reduction still high on the radar of both households and businesses.

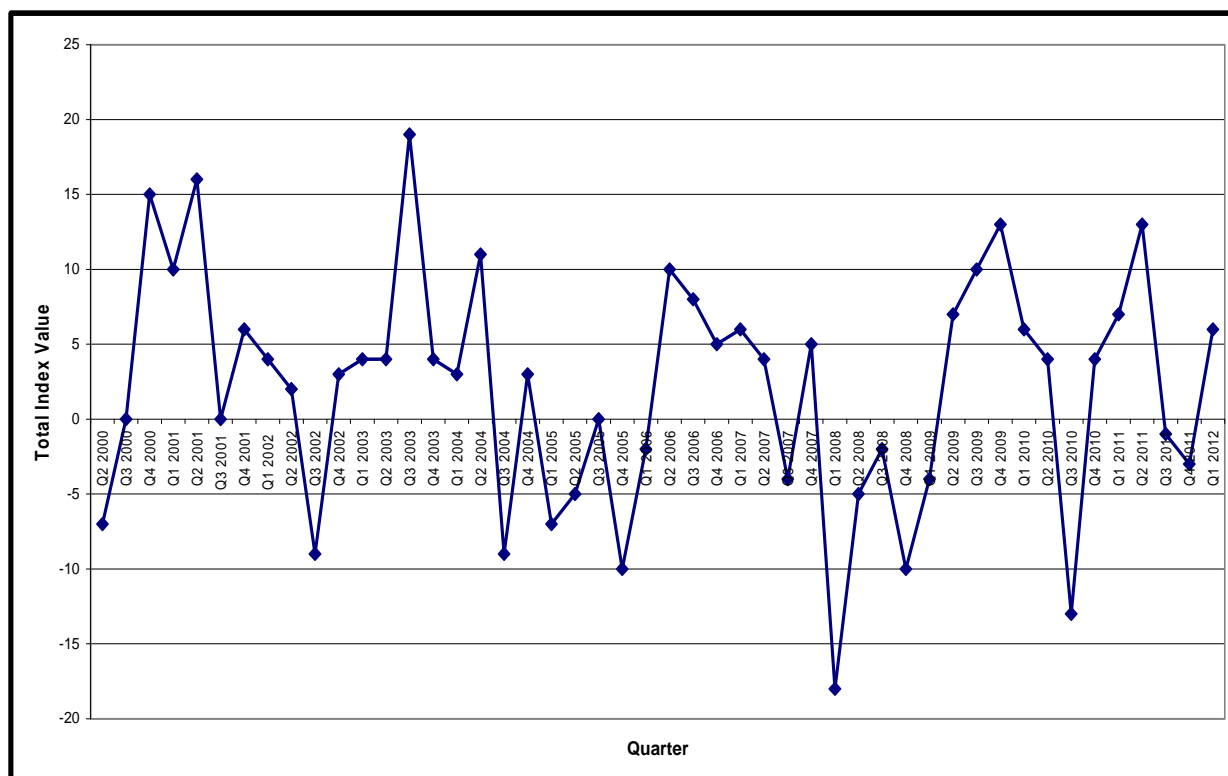
On the political front, the Government has a clear focus on creating a more competitive economy. Business will be keen to ensure that much-needed reforms actually materialise.

**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 March 2012 quarter, up 9 from the previous quarter and down 1 on a year ago.<sup>1</sup>

**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 March 2012 quarter, up 2 on the last quarter and at the same level as a year ago. Despite a continued easing in international commodity prices of late, NZ terms of trade remain relatively sound on the back of relatively strong growth in export volumes.

<sup>1</sup> The ECI tracks 33 indicators on a quarterly basis. The overall index value for any particular quarter represents the net balance of the 33 indicators (generally the number increasing minus the number decreasing) thus providing an overall measure of performance. In general, increases in an indicator are seen as positive (e.g. growth in GDP or employment) and declines as negative. However, this is not always the case. For example, declines in unemployment are seen as positive and increases as negative.

**Monetary policy/pricing indicators sit at -1 for the March 2012 quarter**, down 1 on the last quarter and down 5 on a year ago. Given that inflationary pressures (both domestically and internationally) remain subdued, the outlook for interest rates continues to be relatively stable for the foreseeable future.

**Business/consumer confidence indicators sit at 7 for the March 2012 quarter**, up 8 on the previous quarter and up 9 on a year ago. After a drop in confidence due to global uncertainty late last year, business and consumer confidence levels have sprung back to some extent – although risks remain.

**Labour market indicators sit at -2 for the March 2012 quarter**, the same as the previous quarter but down 5 on a year ago. Recent official data and forward-looking indicators show little change in the outlook both for employment and for unemployment rates.

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

**1.1. Economic growth (GDP) – steady as she goes**

New Zealand can still look forward to growth averaging around 3% for the year to March 2013 and 2014, as outlined in the forecasts below.

**Forecasts: Real GDP % Growth**

	Years Ending		
	Mar 12	Mar 13	Mar 14
Highest	1.8	3.2	3.8
Average	1.7	2.6	3.3
Lowest	1.6	2.1	2.5

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

One factor which has resulted in a lower growth rate for 2013 is the delay in the rebuild of Christchurch. While a number of people are pointing the bone at various individuals and organisations for this delay, the sheer magnitude of the rebuild will mean this is a long slow process, given the complex issues which will have to be worked through.

Despite difficulties with the Christchurch rebuild, New Zealand can continue to feel relatively confident about the future, notwithstanding the uncertain times in which we currently live.

International commodity prices, while in general they have slipped over the last 6-9 months, remain at elevated levels by recent historical standards.

The ANZ Commodity Price Index stands at 285.0 (Feb 2012), down 2.5% on a year ago but still very healthy by historical standards. When converted into NZ dollars, with the impact of exchange rates taken into account, the index at present stands at 186.2, down 10.8% on a year ago and down 4.0% on last month. This reflects the relative strength of the \$NZ over recent months compared with, in particular, the \$US.

**ANZ Commodity Price Index**

	World Price Index	NZ\$ Index
Feb 2008	245.6	175.4
Feb 2009	171.1	179.1
Feb 2010	243.0	189.5
Feb 2011	292.3	208.7
Feb 2012	285.0	186.2

*Source: ANZ (2 March 2012)*

Excellent growing conditions and strong production in the agricultural sector generally have meant that export volumes have stayed high, while returns to producers remain positive as evidenced by a number of surveys.

While Fonterra has trimmed its forecast payout for the 2011/12 season by 15 cents to \$6.75-\$6.85, reflecting reductions in commodity prices and the continued strength of the NZ dollar, returns to farmers are still relatively positive by historical standards. This will provide a further opportunity for debt reduction, which has tended to take a back seat over recent years.

Households, while remaining cautious in terms of retiring debt, are starting to re-open their wallets and this is supporting a gradual improvement in both the retail and building sectors. On the other hand, the labour market is still in the doldrums with little evidence of a substantial up-turn this year, although there will certainly be significant pockets of growth e.g. Christchurch, once the rebuild gets firmly underway.

Subdued inflationary pressures and the likelihood of relatively low interest rates continuing for some time to come will also boost future confidence, despite some tightening in lending policies over recent years.

On the political front, the Government has started its second term with a renewed sense of urgency, which is positive.

In the Budget Policy Statement (16 February 2012) the Government outlined in very broad terms its main priority areas for the current term namely:

- (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, our second biggest city.

All the above priority areas are extremely important in their own right. Nevertheless, perhaps of most concern to the business community and indeed the wider NZ public is the clear focus on creating a more competitive economy.

Without a competitive economy, New Zealand's standard of living will continue to slip and there will be a decline in the goods and services which many New Zealanders take for granted, good education and health services included.

New Zealand's productivity results make pretty poor reading and this was reinforced by recently released 'Productivity Statistics: 1978-2011'. Putting aside the issue of measurement problems, and the fact that the 'measured sector' accounts for only about 80% of the economy, the results are clearly a wake-up call for both policy makers and businesses alike.

Over the growth cycle from 2006 to 2011 annual changes in labour, capital and multi-factor productivity (MFP) were relatively flat or indeed negative, in the case of capital and MFP. MFP is measured as a ratio of output to combined capital and labour inputs. It reflects growth that cannot be attributed to capital or labour, such as technological change or improvements in knowledge, methods, and processes.

- Labour productivity rose 0.5% per year (compared with annual growth of 1.9% from 1978-2011).
- Capital productivity fell 1.9% a year (compared with a fall in annual growth of 0.6% from 1978-2011).
- MFP fell 0.6% a year (compared with annual growth of 0.9 percent from 1978-2011).

There are a number of possible explanations for the continuing low productivity figures. One theory is that the utilisation of capital capacity falls as demand slows, which would lead to a fall in output growth. Another arguable case is that a change in the skill composition of the employed labour force may reduce the average productivity of the labour force. This is possible given relatively low unemployment rates since the mid-2000s. Other theories include the possibility of labour-hoarding i.e. employers reluctant to dismiss staff for fear of significant transaction costs when recruiting new staff as the economy picks up.

While there is likely to be an element of truth in all of the above, perhaps the most concerning fact is that over recent years New Zealand's productivity record has continued to be mediocre.

It is important to understand that there is no one silver bullet that will lift New Zealand's competitiveness. Actions over a range of areas are needed, not just by government, but by businesses and households as well. Key areas to improving competitiveness and economic growth include but are not necessarily limited to: (1) the quality of land, labour and capital as key inputs, (2) ensuring secure and transparent property rights, (3) macroeconomic stability, and (4) increasing productivity. Within these key areas there is a wide range of actions the Government (and in some cases businesses and households) can take to lift New Zealand's competitive position.

## 1.2 Monetary Conditions – global changes having impacts

### *Interest rates – on hold*

The 90-day bill rate is forecast to increase slowly and reach 3.6% by March 2013 and 4.5% by March 2014 as evidenced in the forecasts below.

**Forecasts: Interest Rates (90 day bills)**

	As at end of		
	Mar 12	Mar 13	Mar 14
Highest	2.8	3.8	4.7
Average	2.7	3.6	4.5
Lowest	2.7	3.5	4.2

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

The Reserve Bank, not surprisingly, has left the Official Cash Rate (OCR) unchanged at 2.5 percent in its latest Monetary Policy Statement (8 March 2012).

Reserve Bank Governor Alan Bollard said: *“Inflation has settled near the middle of the Bank’s target range, and inflation expectations have fallen”* He stated that the domestic economy is showing some signs of improvement while policy actions from a number of central banks around the world have boosted global confidence. While this could be considered positive overall, it has resulted in a recovery in risk appetite and has therefore led to an appreciation in the NZ dollar, particularly against the \$US. This obviously has positive implications, in terms of containing inflation, while at the same time being detrimental to the tradable sector.

In an innovative move, the New Zealand Institute of Economic Research (NZIER) has formed a 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.

The board spans a diverse set of expert opinion across senior bank economists, business leaders and academic economist. The Shadow Board is totally independent of the Reserve Bank of NZ.

The NZIER Shadow Board aims to achieve three goals:

- To encourage informed debate on each interest rate decision;
- To help inform how a board structure might operate relative to New Zealand’s current single decision-maker model, where the Governor is solely responsible for making each decision; and
- To explore individual board members using probabilities to express their uncertainty.

In its first review, 68% of the collective weighting was given to ‘no change’ (i.e. OCR remaining at 2.5%), while 27% of weightings were targeted at a lower rate. 5% of weightings suggested a slightly higher rate of 2.75%.

It could be argued that there was little chance of a change in the OCR at the time of the latest review, but it will be interesting to see the responses of the Shadow Board, particularly where economic arguments for or against a rate rise (or reduction) become more pronounced over time.

### *The New Zealand dollar – volatility will continue given global influences*

Forecasts below show the NZ dollar is likely to fluctuate significantly, depending on who one talks to. This underpins the huge difficulty of making predictions about the future direction of the dollar, given the potential of global influences to impact significantly on it.

As the Reserve Bank Governor stated in the latest review of the OCR (8 March 2012): *“Policy actions from a number of central banks have boosted global confidence. While encouraging, financial market sentiment remains fragile and risks to the global outlook remain. Furthermore, the easing in global monetary policy and resultant recovery in risk appetite has contributed to a marked appreciation in the New Zealand dollar.”*

In other words, the recent strength of the NZ dollar relative to some of our major trading partners has little to do with the relative strength of the NZ economy, but much more to do with the pump priming of monetary policy in some countries which artificially inflates the attractiveness of commodity based currencies such as NZ.

**Forecasts: Exchange Rates**

AUD (cents)			
	Mar 12	Mar 13	Mar 14
Highest	0.775	0.825	0.820
Average	0.768	0.799	0.809
Lowest	0.760	0.770	0.789

USD (cents)			
	Mar 12	Mar 13	Mar 14
Highest	0.850	0.900	0.870
Average	0.796	0.828	0.788
Lowest	0.750	0.780	0.750

TWI			
	Mar 12	Mar 13	Mar 14
Highest	73.5	76.6	76.0
Average	70.6	73.4	71.9
Lowest	67.6	70.5	69.0

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

*Inflation - well within the Reserve Bank's target range*

Forecasts outlined below show inflation as likely to be well within the Reserve Bank's target range of 1-3% for the year to March 2013, although that limit will be under pressure in the year to March 2014 when inflation is forecast to reach 2.8%. The Reserve Bank has substantially slashed its inflation forecasts, although it could be argued that it is being a little optimistic in its prediction of low inflation. Time will tell.

Several factors are currently putting downward pressure on inflation. First, a relatively subdued global economic outlook is ensuring that resource constraints are minimal and thus traditional key commodity drivers of inflation (e.g. oil) are relatively contained.

Second, as mentioned earlier, international commodity prices have come back somewhat over the last 6-9 months. This means that pressures on domestic prices are also contained, given that ultimately, it is the international commodity price that drives domestic prices.

Third, the high value of the NZ dollar, while detrimental to the tradable sector, will help contain any inflationary pressures.

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 pressures for skilled trades people as the Christchurch rebuild gains momentum.

Despite subdued expectations for inflation, over coming months there could be some upward pressure on household budgets generated by the increasing cost of insurance (health and property-related) as a result of the earthquakes and a general re-pricing of insurance risk. But on the other hand, there will also be a substantial reduction in work and non-work (earner) accident (ACC) levies.

**Forecasts: % Change in Inflation (CPI)**

	Years Ending		
	Mar 12	Mar 13	Mar 14
Highest	1.8	2.5	3.0
Average	1.7	2.3	2.8
Lowest	1.6	2.1	2.5

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

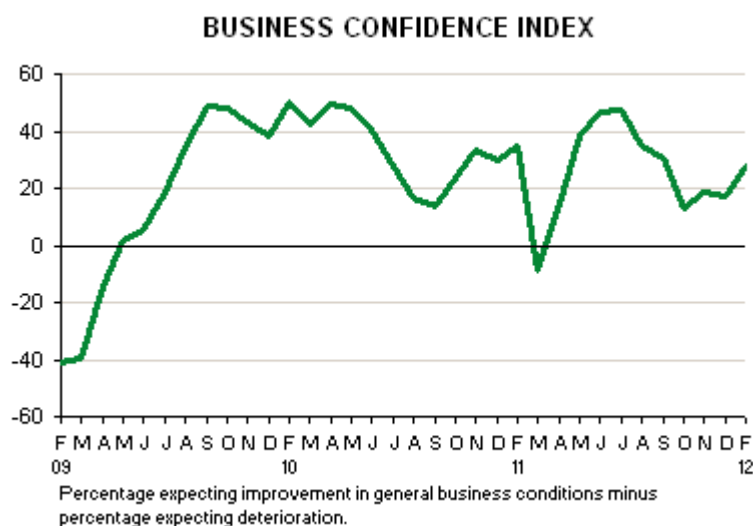
### 1.3 Business and consumer confidence – bouncing around but still positive overall

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

A number of surveys show business confidence generally drifting higher after the slump experienced in the fourth quarter of 2011. Both the BNZ Confidence Survey and the National Bank’s Business Outlook show relatively solid improvement from late last year. The BNZ Confidence Survey recorded a rise in business sentiment to a six month high with strength in agriculture, and construction showing improvement. On the other hand, retailing is still very mixed with heavy discounting to move stock.

The National Bank’s Business Outlook (February 2012) shows a net 28% of businesses expecting better times for the economy over the coming year, up 11 points on the end of 2011. Confidence lifted across all the five major sub-segments with the construction sector now the most confident in regard to the general business environment, perhaps not unexpected in view of the potential rebuild of Christchurch and the fact that housing construction has been in the doldrums for a number of years now.

**National Bank Business Confidence Index**



Some of the key highlights from the survey include:

- A net 31% of businesses expect an improvement in activity for their own business over the year ahead (up 5 points on December 2011).
- Employment intentions rose from +5 to +8.
- Export intentions increased from +16 to +19.
- Profit expectations increased from +8 to +10.

However, investment intentions dropped slightly from +14 to +11.

While it is easy to say that such levels of confidence suggest growth rates of around 3-4% per annum as was commonly the case with similar survey results in the past, the big difference is the fact that international markets are still relatively unstable and survey expectations are not necessarily being translated into actual investment decisions.

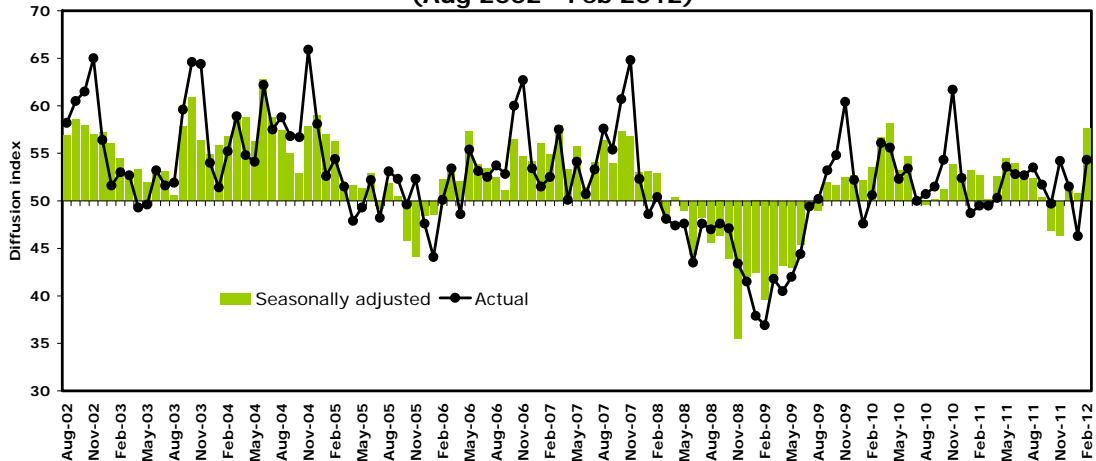
After contracting in both October and November 2011, the BNZ-BusinessNZ Performance of Manufacturing Index (PMI) has bounced back into positive territory for the start of 2012 with a very good result recorded for the month of February.

In February the PMI (seasonally-adjusted) stood at 57.7, 6.9 points up from January and the highest level of activity since April 2010. A PMI reading above 50 points indicates manufacturing activity is expanding; below 50 indicates it is contracting.

Four of the five seasonally adjusted indices which make up the overall PMI were in expansion during February, led by *new orders* (63.1) and *production* (61.9), both recording their highest result since 2004. *Employment* (51.3) was largely unchanged from January, as was *finished stocks* (49.0). *Deliveries* (54.0) increased 3.8 points from the previous month to record its highest level of activity since August 2011.

Obviously one should not get too bullish about the results of one month but the strength of key indices (new orders and production) justifies some optimism.

**BNZ - BusinessNZ Performance of Manufacturing Index Time Series (Aug 2002 - Feb 2012)**

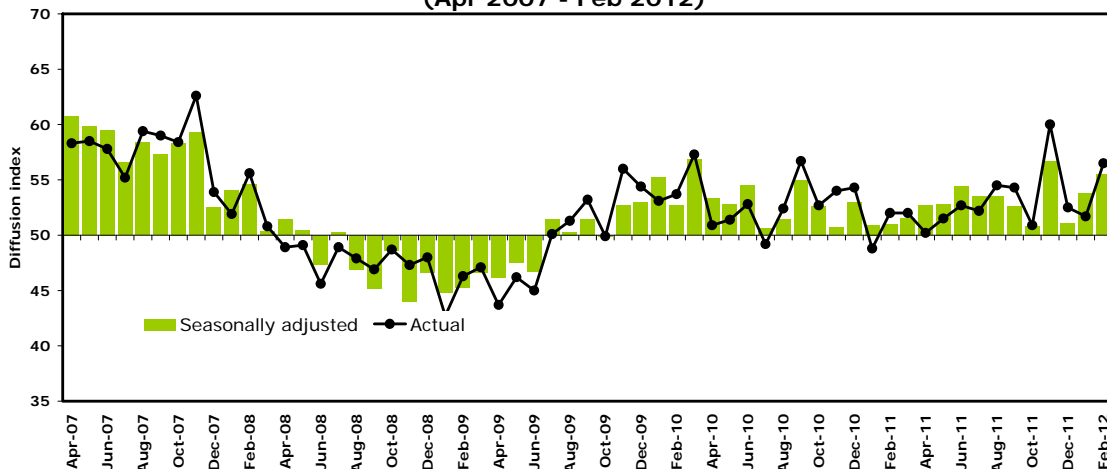


Source: BusinessNZ

The seasonally adjusted BNZ-BusinessNZ Performance of Services Index (PSI) for February 2012 (55.5) also shows a relatively strong result – up 1.7 points from January and up 4.4 points up from December 2011.

All five seasonally-adjusted indices which make up the PSI showed expansion in February. This was again led by *new orders/business* (60.5) followed by *activity/sales* (58.1) which increased 4.3 points from January. The other indices, *employment*, *supplier deliveries*, and *stock/inventories* were all in positive expansion mode as well.

**BNZ - BusinessNZ Performance of Services Index Time Series (Apr 2007 - Feb 2012)**



Source: BusinessNZ

Other sectors remain mixed. 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.

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

Generally favourable spring and summer growth conditions and continued world demand for protein have seen agricultural producer prices remain at reasonable levels despite some slippage over the last 6-9 months.

Fonterra has reviewed its projections for the 2011/12 season payout and has made a slight downward adjustment, although the forecast payout is still relatively high by historical standards.

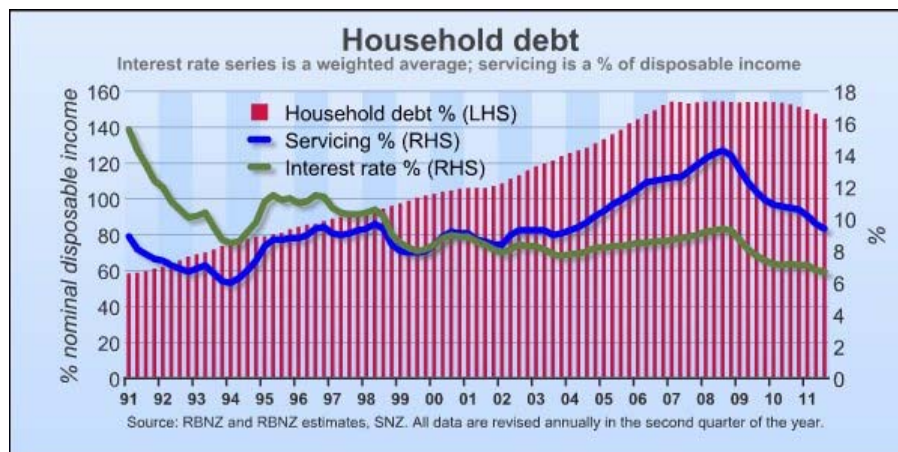
Not unexpectedly, farmers continue to be very much focused on debt reduction but the service sector and wider economy should benefit once they start opening their wallets again.

*Consumer confidence – in positive territory but going nowhere*

Consumer confidence, like business confidence, has bounced around over recent times but is still in positive territory.

The ANZ-Roy Morgan NZ Consumer Confidence Survey (15 March 2012) shows consumer confidence, while positive, easing back from 113.3 in February to 110.2 in March, indicating consumers as still relatively nervous, with their concerns influencing general expenditure patterns.

Household debt, as a percentage of disposable income has fallen from close to 160% in 2007 to around 140% currently as can be seen below. A key driver has been a protracted period of relatively low interest rates which has helped households to reduce debt. Debt servicing costs have dropped from around 15% of disposable income in 2008 to around 8% currently. The personal income tax cuts in 2011 would also have boosted real disposable income for many households.



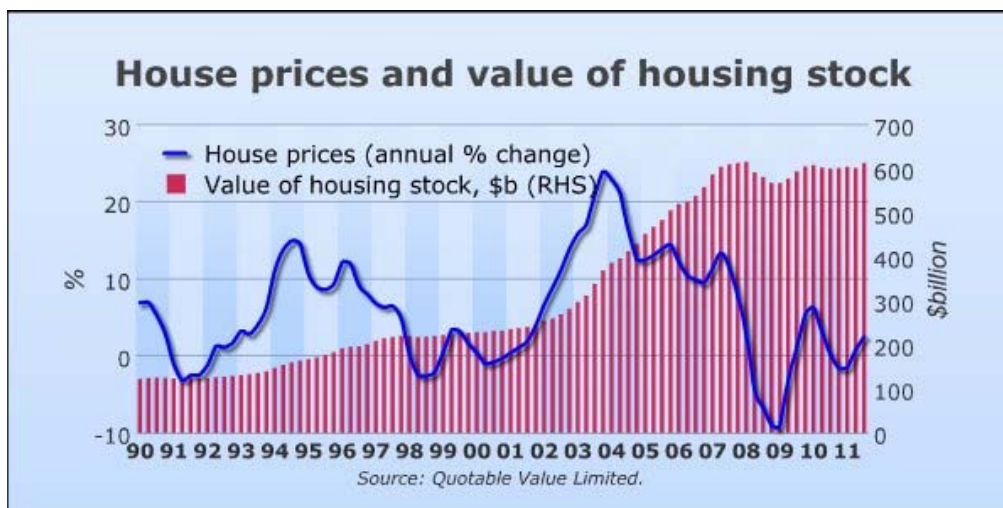
Notwithstanding reductions in debt, consumers continue to take a cautious approach to expenditure as evidenced by the relatively slow growth in electronic and retail sales' data. Retailers are continuing to discount heavily in order to move stock. Core retail sales have been flat since mid 2011.

The housing market is showing significant signs of recovery although the latest available figures need to be put in context, given the nature of the housing market over the last 2-3 years.

While volumes of sales are up 37% compared with the same time last year (and the best February result since 2008) it should be noted that the February 2012 result is only two-thirds of the sales recorded in February 2007.

Median house prices remain relatively steady but are up slightly on a year ago. Clearly, an improvement in the asking price does not necessarily translate into actual sales.

Perhaps the clearest indicator of whether there is significant pressure on housing (apart from the obvious price indicator) is the length of time taken to sell a house. The national median 'days to sell' fell 1 day in February 2012 compared with January, that is, from 47 to 46 days. However, this is still significantly greater than the 41 median days taken to sell a house over the last 5 years, across NZ.



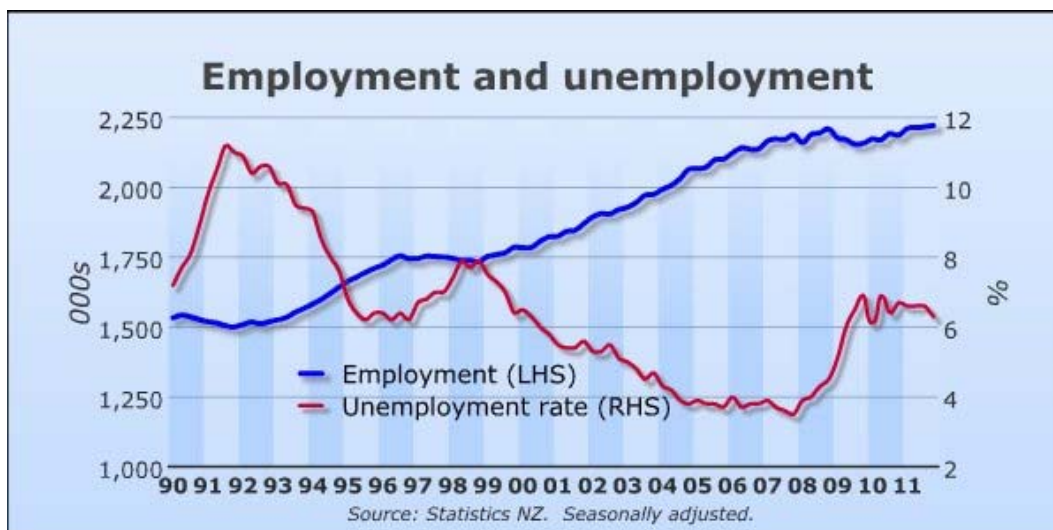
In line with an improvement in the housing market, construction is increasing but offset to some degree by the net outflow of migrants from NZ, mainly to Australia.

A rather benign outlook for inflation should also be positive for consumer confidence, not only in respect to the outlook for interest rates but also in terms of household budgets.

#### 1.4 Labour market – slow growth

*Employment – edging upwards but headline figures do not necessarily tell the full story*

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



The results of the Household Labour Force Survey (HLFS) for the December quarter 2011 (the latest available), while reasonably positive on the surface, if analysed a little more, show the labour market as still relatively soft.

Yes - the unemployment rate did drop to 6.3% (down 0.3 percentage points on the previous quarter) but the labour force participation rate dropped from 68.4% to 68.2%, a useful measure of labour market strength.

At the same time while there was a slight increase in employment overall, this was driven solely by an increase in part-time employment (up 15,000 or 3%) while full-time employment decreased by 13,000 (0.8%).

This result can be seen two ways. On the positive side, an increase in part-time employment can indicate the early stages of a labour market up-turn as employers 'test the water' in terms of new employment growth.

On the negative side, the result could indicate soft labour market conditions given that male part-time employment rose 7.1% while male full-time employment fell 1.6%. By contrast, both full-time and part-time female employment numbers increased slightly for the December quarter (up 0.4 and 1.5%, respectively).

Notwithstanding the above, the results for the HLFS over a number of quarters now have tended to yo-yo somewhat, making it difficult to determine with any accuracy whether or not a quarterly change is likely to be part of an upward trend. This is where forward looking indicators, such as job ads, can provide a clue to future labour market conditions.

The ANZ NZ Job Ads series, which sums newspaper and internet ads (on a weighted basis), rose 5.3% in February (on a seasonally-adjusted basis), which effectively only recovered the ground lost over the preceding two months.

Regional differences remain. Total job ads in Auckland rose 9.1% (on an unweighted basis) while Christchurch recorded a rise of 4.2%. Conversely, Wellington job ads fell 5.5%.

The series, and a number of other forward-looking surveys, would suggest that the labour market is likely to continue to move sideways with only a small improvement in the unemployment rate likely in the near term. There is no evidence of a generalised upswing at this stage.

**Forecasts: Unemployment % (HLFS)**

	Quarter		
	Mar 12	Mar 13	Mar 14
Highest	6.4	6.1	5.8
Average	6.3	5.8	5.2
Lowest	6.1	5.7	4.8

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

*Labour costs – continue to be subdued*

Forecasts below indicate that labour costs are expected to increase slowly to around 2.4% for the year ending March 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.

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

	Years ending		
	Mar 12	Mar 13	Mar 14
Highest	2.3	2.5	2.8
Average	2.2	2.2	2.4
Lowest	2.0	1.9	2.1

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