Business Planning Forecast
June 2007

Executive summary – positive signs emerging

Economy

A number of indicators show the New Zealand economy is continuing to perform at reasonable levels. Commodity prices are up, with a stronger world economy and a drought in Australia good news for New Zealand's commodity producers. The recent announcement from Fonterra for a significantly improved pay-out to dairy farmers for the 2007/08 season will boast returns to rural communities and potentially prop-up rural land prices as dairy conversions become even more attractive, given that sheep meat and wool prices have been in the doldrums.

On the other hand, inflationary pressures remain an issue boasted by a third wind in the housing market and continued buoyant consumer spending. Pressure will be on the Reserve Bank to increase interest rates even further. However, the export sector will bear the brunt of any further rises through added pressure on the NZ dollar. Business and consumer confidence are steady after improving from the lows recorded last year.

Budget 2007

Apart from the widely anticipated business tax cuts and research and development (R&D) tax credits, the Budget was largely business as usual. The only significant item from left field was the government's decision to require compulsory contributions from employers whose employees join Kiwi-saver. The implications on costs could be significant and will certainly impact on wage bargaining negotiations over the next 3-4 years as the scheme rolls out. In summary, the Budget was very much a Budget of "give on the one hand and take on the other". Businesses and individuals may rightly feel aggrieved.

<u>About the Business Planning Forecast Report</u>

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 put together by the UK-based magazine "The Economist". Sources of other information are as shown.

We stress that the information in this report is of a general nature. Your firm is unique, and you will need to make your own decisions. However, we believe the better informed you are about the way various business people see the future, the better the decisions you can make.

Where appropriate we have included averages alongside the highest and the lowest forecasts. This gives some idea of the spread of forecasts and therefore of the uncertainty involved.

<u>HIGHLIGHTS</u>

- **World commodity prices are up which is good news for New Zealand commodity producers, particularly dairy.**
- **Inflationary pressures remain a key concern with pressure on the Reserve Bank to raise interest rates even further.**
- **The Budget was very much a matter of "give and take" with reductions in the company tax rates and R&D tax credits offset by added costs on employers through compulsory contributions to KiwiSaver from April 1, 2008.**
- **Labour market conditions remain tight but labour productivity growth should be a key concern for both policy makers and businesses alike.**

Part 1: The New Zealand Economy

1.1. Economic growth (GDP) – modest by recent standards

Most recent outcome: 1.5% for the year to December 2006.

Gross Domestic Product (GDP) is the measure of a country's total economic activity over a given period. Since 2000, GDP growth has averaged 3.5% per annum, indicating a strongly performing economy with growth rates higher than those of many countries to which New Zealand compares itself. However, that growth has now severely slowed, being only 1.5% for the December 2006 year.

Quarterly results show economic activity increasing 0.8% in the December 2006 quarter, following an increase of 0.3% for the September quarter and 0.4% during the June 2006 quarter. Since March 2004, only one quarter (June 2005) has shown growth at 1% or more.

The ongoing strength of the services sector was the major contributor to growth in the December 2006 quarter, while the manufacturing sector weakened the overall result. The service industries recorded their seventeenth consecutive quarterly increase, up 0.9% in the December 2006 quarter. These results are consistent with Business NZ's new survey -- the Performance of Services Index (PSI) -- which shows the PSI sitting at 58.3[1]. (A number over 50 represents expansion while a number below 50 represents contraction).

Domestic and household consumption is still strong, with domestic spending increasing by 2.6% for the December 2006 quarter and household consumption up 1.1% (up 0.4 and 0.3% respectively on the previous quarter).

The continuing trend of lower quarterly growth obviously does not provide enough impetus for New Zealand to head towards the top half of the OECD. However, there appears to be some light at the end of the tunnel, with expectations that GDP has all but bottomed out and will increase over the forecast period, as shown in the table below.

Forecasts: Real GDP % Growth

	Years Ending		
	Jun 07	*Jun 08*	*Jun 09*
Highest	2.8	2.6	3.3
Average	2.4	2.2	2.5
Lowest	2.0	1.9	1.8

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

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

Interest rates – leading the charge

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 due to continued inflationary pressures in the economy. While expectations are that the United Kingdom and possibly Australia may raise their official interest rates, the gap between NZ and our major trading partners continues to be significant.

Official Interest rates

Central Bank	**Current rate (%)**	**Previous rate (%)**
Reserve Bank of Australia	6.25%	6.0%
US Federal Reserve	5.25%	5.0%
Bank of England	5.50%	5.25%
European Central Bank	3.75%	3.50%
Reserve Bank of NZ	7.75%	7.50%

Some commentators expect the Reserve Bank to follow up the two rises its already made to the OCR this year with further increases. While others debate whether the Reserve Bank will put any further rises on hold, there is a general consensus that any drop in the OCR will be a long time coming.

Unlike its previous statements, the Reserve Bank's most recent on April 26 was reasonably neutral, not outlining any "track" for interest rates for fear of painting the Bank into a corner. However the statement did warn of the need to remain vigilant about

[1] http://www.businessnz.org.nz/doc/1204/NewPSIsurveychartsservicegrowth

potential medium-term inflationary pressures and implied any interest rate reductions are a significant way off.

On balance, we would be surprised if the next movement in the OCR is upward, not because inflationary pressures are not present, but because further rises are likely to have an adverse impact on exporters by imposing further pressure on the dollar while having limited impact on households -- the primary drivers of inflationary pressures.

Business NZ recently published a booklet *"OCR: The Sharpest Tool in the Box?"*[2] outlining a number of support mechanisms to help the OCR control inflation. While there are several possibilities, further investigation finds most have fundamental weaknesses or the potential for adverse, though unintended, consequences. The Finance and Expenditure Committee has announced it will be carrying out an inquiry into monetary policy in New Zealand. However, for this to be effective it must consider all potential mechanisms and address regulatory and fiscal burdens on the economy. At this stage, the inquiry's terms of reference only include productivity growth, potential growth and how monetary and fiscal policies interact.

Despite the view that the OCR has peaked, there are several inflationary concerns still prevalent both domestically and internationally.

On the international front, world oil prices have rebounded from a year ago given increased instability in the Middle East. New Zealand's higher dollar is to some extent currently cushioning households and businesses from further price rises, although this cannot last forever.

On the domestic front, recent business opinion surveys show firms' expectations of raising prices as still reasonably strong.

Given reasonably tight labour market conditions, the potential for further wage pressures should not be ruled out, particularly with the introduction of compulsory employer contributions to Kiwisaver from April 1 next year. This requirement will add a new twist to wage negotiations over the next few years.

Finally, the 2007 Budget predicts inflation will remain relatively high and is projected to peak at 2.7% in the year to March 2008 and only slowly moderate thereafter. Given that this is close to the top of the Reserve Bank's target inflationary band (1-3%), there's likely to be little room for interest rate cuts over the near term.

The New Zealand Dollar – anyone's guess?

Our analogy of someone firing arrows at a dartboard when trying to predict the short-term direction of the NZ dollar continues to be bang on the money.

The first half of 2006 saw a steady drop in the value of the New Zealand dollar and this was long overdue as the general consensus was that it had been too high for too long. Many believed that as the steam started to go out of the New Zealand economy, so would demand for the dollar, and increasing interest rates offshore would lure investors elsewhere for returns. However, from August onwards that view changed. The dollar has since been on an upward path against all major currencies, eclipsing all the fall experienced during the first half of 2006.

There are several drivers for the higher dollar. Higher commodity prices have helped but the primary driver is likely to be the higher real interest rates compared with our major trading partners. International investors, perhaps naively, have continued to flood New Zealand with the expectation of high returns, apparently blissfully unaware or ignorant of the potential for a significant drop in the NZ dollar which would erode any gains from higher interest rates. Nevertheless, to date they have been the winners with, the NZ dollar staying at historically high levels.

The impact of a high dollar on exporters has been partially offset by higher commodity prices, particularly in dairying which has resulted in Fonterra offering a significantly higher price for milk for the 2007/08 season. However, those who expected the dollar to keep dropping off earlier this year, and therefore failed to adopt a prudent hedging strategy, are now likely to be bearing the brunt of the dollar's rise.

Although one would expect the NZ dollar to head southwards over the coming year, determining the timeframe and level is difficult at best. The Reserve Bank would hope any fall is gradual, rather than a sudden short-term adjustment that might boost tradeables' inflation.

Budget forecasts expect the exchange rate (as measured by the Trade-weighted Index – TWI) to drop substantially over the next three to four years, from 71 cents currently to 54.5 cents by 2011.

Net migration flows – cooling

Over the past four years, large migration inflows have boosted domestic consumer spending, car sales and house building. Migration has also, to an extent, helped mitigate some of the pressures that have built up in the labour market.

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 this year net migration figures have drifted downwards, not significantly (to 11,200 per annum as at April 2007) but, as a good leading indicator of economic activity, enough to suggest that the economy is likely to meander along for the next two to three years.

[2] http://www.businessnz.org.nz/doc/1196/OCRThesharpesttoolinthebox

Stable growth in net migration figures will help hold up the property market, as people arriving in the country obviously need somewhere to live. Although one could argue that the property boom of 2000-2003 -- where capital gains in some areas were nothing short of spectacular -- is over, latest figures show the trend is still positive, with evidence of increasing activity in a number of areas. There is also evidence that the latest continued rise in house prices is not a short-term trend given that the number of days to sell a house is the same as a year ago and investors and homeowners are still investing despite rising interest rates and negative returns. The lure of potential capital gains still appears to be alive and well and is continuing to put upward pressure on prices.

Indications are that home ownership is declining further as first home buyers find it increasingly difficult to get on the first rung of the housing ladder. Rents, in general, currently do not reflect reasonable economic returns on capital invested, suggesting either that investors are continuing to expect capital gains on housing will continue or that rents will move up to more “acceptable” levels.

The concern about housing affordability is such that a Select Committee is looking into the matter. New Zealand house prices have doubled in the last five years, and home ownership rates have fallen over the last 15 years. While there are no easy answers, serious consideration needs to be given to determining the amount of land available for housing sub-division. Current constraints add a significant cost to the price of sections which in turn flows on to the price of all housing, both existing and proposed.

The Budget included an allowance of about $14 million for the Department of Inland Revenue to undertake greater auditing of house sales to ensure that those people actively trading in housing stock pay tax on the capital gains. There is some question as to how actively IRD has been in enforcing current tax rules relating to housing. Whether greater auditing will uncover significant scams is arguable and the extent to which it will impact on overall house prices is highly debatable.

Commodity prices – world and NZ dollar commodity price indexes continue to expand

A surge in international dairy prices has underpinned a strong rise in the ANZ World Commodity Price Index. Dairy products account for nearly a third of the ANZ index, and have pushed up the overall index by 4.8% for the month to reach a new record high of 180.3 for April 2007. The overall index is now up 21 percent from where it stood a year ago. The latest rise in world dairy prices is directly related to the Australian drought restricting the supply of dairy products in international markets.

When converted into $NZ, the ANZ NZ Dollar Commodity Price Index rose a modest 0.1% in April 2007 to reach 134.1 – an annual increase of just 4.7%. This shows that while international prices increased strongly over the year, these gains were almost totally wiped out when converted into NZ dollars. On the other hand it also shows that strong international commodity prices are acting as a useful buffer for some industry sectors against the high NZ dollar.

	World Price Index	Monthly % Change	Annual % Change	NZ$ Index	Monthly % Change	Annual % Change
April 2002	115.4	0.1	-9.4	132.0	-2.1	-17.1
April 2003	119.6	-1.2	3.6	112.9	-0.8	-14.5
April 2004	140.9	2.7	17.8	117.7	5.7	4.3
April 2005	156.6	0.0	11.1	117.3	1.6	-0.3
April 2006	149.2	1.6	-4.7	128.1	3.9	9.2
April 2007	180.3	4.8	20.8	134.1	0.1	4.7

Source: ANZ Commodity Price Index NZ – 3 May 2007

Business confidence – stable after earlier rebound

Business confidence influences the propensity for businesses to invest in capital and employ staff, and is therefore an important determinant of future economic growth.

The NZIER’s Quarterly Survey of Business Opinion (QSBO) shows business confidence has stabilised after a period of extremely low confidence levels 18 months ago. General business confidence was steady according to the March 2007 quarter results. On a seasonally-adjusted basis, a net 3% of firms expect the general business situation to deteriorate in the next six months. This compares with a net balance of 7% in the December 2006 quarter and 24% in the September quarter. The latest quarter shows some stability after the negativity experienced 18 months ago when a net 72% of firms expected conditions to deteriorate.

A more reliable indicator of business confidence is the activity levels of individual firms, and the March quarter results show confidence among firms continuing to improve. On a seasonally-adjusted basis, the net balance of firms reporting an increase in their own activity was 11%. For the previous quarter the net balance was 6%, on a seasonally-adjusted basis.

Improvement in the business outlook across sectors is mixed. The service sector continues to boom as evidenced by the results from a number of surveys, including Business NZ’s PSI that measures actual activity levels. On the other hand, the manufacturing sector showed a decline in optimism with a net 23% of New Zealand manufacturers expecting the general business situation to deteriorate compared with a net 5% of Australian manufacturers. This is likely to reflect the pressures on exporting manufacturers from NZ dollar. 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. On the other hand, Business NZ’s Performance of Manufacturing Index (PMI) shows manufacturing activity is holding up reasonably well with the latest PMI sitting at 54.2 for April 2007 – a slight slow-down from recent months but nevertheless, still relatively robust growth.

Consumer confidence – robust

Consumer confidence eased slightly from 119.7 in the December 2006 quarter to reach 117.7 for the March quarter 2007. While the slight fall over the latest quarter partially reverses the sharp gain at the end of 2006, consumer confidence is still significantly higher than at the same time last year. An index number over 100 indicates there are more optimists than pessimists, while a number under 100 indicates that pessimists outnumber optimists.

While confidence concerning consumer purchasing power increased for the March 2007 quarter, there was a decline in consumers' perceptions of the economic outlook in 12 months' time relative to their current financial situation. This may partially be driven by the fact that interest rate rises have started to bite as more and more households are exposed to refinancing fixed rate mortgages and petrol prices have risen by about 15 cents a litre since the December 2006 confidence survey. On the other hand, family incomes have been boosted through the Government's Working for Families package, together with "paper" wealth gains through a reaccelerating housing market.

1.2 Inflation – pressures persist

Most recent outcome: +2.5% year-ended March 2007

The rate of inflation, as measured by the Consumer Price Index (CPI), provides an indication of the extent to which price levels have increased and an indirect benchmark for wage demands. It is also the key reference point for monetary policy.

The March quarter 2007 Consumers Price Index (CPI) rose 0.5% on the December 2006 quarter, bringing headline inflation down slightly from 2.6% annually to 2.5%. Housing and household utility prices rose 1.1% for the latest quarter, driven by higher prices for rental housing and the purchase of new housing. Food prices also rose 1.1%. On the other hand, transport costs declined slightly, mainly driven by lower prices for international air transport. Declines in household goods also had an impact on the CPI for the quarter.

In the March 2007 quarter, non-tradable inflation increased to 1.2%, following a 0.8% rise in the December 2006 quarter. Tradeables inflation decreased for the second consecutive quarter, dropping by 0.4% in the March quarter after a fall of 1.3% in the December quarter 2006.

From the March 2006 quarter to the March 2007 quarter, the non-tradable component increased 4.1% and the tradeable component increased 0.9%

While housing market resurgence, buoyant consumer spending and solid, if not spectacular, business and consumer confidence may be making the Reserve Bank nervous, further interest rate hike would clearly be unhelpful, compounding exchange rate pressures while having limited effect on consumer behaviour – the real target. Nevertheless, the Reserve Bank and indeed the Government should be concerned about the prolonged growth in non-tradeables' inflation.

Forecasts below show that inflation will remain around the 2.5% mark for the next three years, although it will pick up slightly in 2009. While this is within the 1-3% medium term range that the Reserve Bank is responsible for, it does not leave significant scope for any shocks or up turns in the New Zealand economy that may stir up inflation levels. These forecasts are broadly in line with those contained in the recent Budget.

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Jun 07	*Jun 08*	*Jun 09*
Highest	2.2	3.4	3.1
Average	1.9	2.5	2.7
Lowest	1.6	1.5	2.5

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

1.3 Labour costs – wage pressures persist

Most recent outcome: +3.1% -- year-ended December 2006

Statistics NZ produces an index that measures movements in the total cost of employing labour, the Labour Cost Index (LCI). The LCI has fixed industry and occupation weights and measures changes in wages and salaries for a fixed quantity and quality of labour input. As such, the LCI is preferred by the Reserve Bank as a measure of labour costs.

As expected with a reasonably tight labour market, wage pressures are continuing with stronger demand for labour causing skill shortages in a number of industries and regions, pushing up average labour costs. To a certain extent these are flowing through into general wage pressures across the economy as a whole.

Private sector salary and ordinary time wage rates (as measured by the LCI) show increases of 0.7% for the March 2007 quarter, taking the annual rate up to 3.0%.

While wage pressures are expected to ease slightly over the coming year as the labour market cools, workforce expectations remain for significant increases. This situation has not been helped by the traditional practice of linking wage rises to the CPI.

While official data on work stoppages (strikes/lockouts) is dated, there have been a number of 'high profile' strikes of late, mainly in the public sector. It may well be that further strikes and/or lockouts will continue to feature in future wage negotiations as advantage is taken of the current tight labour market conditions.

Forecasts: Labour Cost Index % Change

	Years Ending		
	Jun 07	*Jun 08*	*Jun 09*
Highest	3.2	2.8	2.8
Average	3.2	2.7	2.7
Lowest	3.1	2.6	2.5

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

An alternative measure of labour costs is the Quarterly Employment Survey (QES). This tends to be much more volatile than the LCI, mainly because it reflects compositional changes in the labour force. The Budget forecast for growth in average ordinary time earnings is expected to decline slightly from 4.8% currently, but remain solid at around 4.0% per annum out to 2010.

While the forecasts above suggest that labour costs have peaked and will ease slightly over the next couple of years, the direction of future wage and salary movements is likely to be complicated by a number of factors. Among these are the entitlement of all employees to four weeks' annual leave (with potential relativity arguments arising from this), the introduction of the Kiwisaver scheme mid-year, and the implications for real wage rises of the Working for Families scheme's abatement regime.

The net cost of Kiwisaver to employers could be significant given the phase-in of a compulsory employer contribution from 2008. These will start at 1%, progressively increasing to 4% by 2011/12 (see below).

KiwiSaver Contributions (2008-2011)

From	Min employee contribution (% of gross salary)	Employer contribution (% of gross salary)	Total employee and employer contribution (% of gross salary)
1 April 2008	4%	1%	5%
1 April 2009	4%	2%	6%
1 April 2010	4%	3%	7%
1 April 2011	4%	4%	8%

Employers will be (partially) reimbursed for the cost of matching contributions by the government through the new tax credit capped at $20 per employee per week ($1,040 per employee per year).

In effect, this means that for employees earning less than $26,000 per annum, the net cost for employers of their contribution would be zero (i.e. $26,000 multiplied by 4% equals $1,040 (the tax credit)). For employees earning $52,000, the net cost to employers providing 4% contribution would be 2% of salary. For employers earnings, $104,000, the net cost would be approximately 3% of salary.

The Minister of Finance has stated in the Budget that *"The employer tax credit makes it much easier for employers to provide matching contributions. In the first year, it will meet the full costs of the contributions for 95% of the workforce. Overall, the net additional costs to employers by 2011/12 should overall be no more than one percent of the national wage and salary bill at that point."*

While technically, the above statement appears robust, it probably reflects an expectation that only about 50% of employees will take up the Kiwisaver option. This fails to acknowledge the scheme's impact on employers whose entire workforce opts to join KiwiSaver. Taking into account likely increases in wages and salaries, the real net cost for employers whose entire workforce takes up Kiwisaver could well be in excess of 2% per annum.

Two issues arise here. First, this is likely to impact on the wage negotiation process over the next few years. Second, and perhaps more subtly, the Government's decision to lower the company tax rate to 30% and introduce a 15% R&D tax credit, while partially subsiding the employer's compulsory contributions to Kiwisaver, is likely to be totally offset by the compulsory requirement to contribute to Kiwisaver.

Unlike, the changes in the company tax rate and R&D tax credits (which are specifically "targeted"), employer contributions to Kiwisaver will impact on every employer. To therefore state that employers will be better off as a result of the tax package could be misleading. Some employers will be significantly better off (particularly companies with large R&D budgets) which will benefit both from a reduction in the company tax rate and through the R&D tax credit. On the other hand, those individuals who operate as sole traders or who are not incorporated will effectively miss out, hence the view that the Budget has been very much a matter of "give and take".

1.4 Employment – remaining tight

Most recent outcome: +1.7% year-ended March 2007

The labour market continues to operate at close to full capacity given current constraints.

The latest Household Labour Force Survey shows seasonally-adjusted employment was up 25,000 for the March quarter 2007 while on the other side of the coin, the unemployment rate increased marginally to 3.8%. The seasonally-adjusted labour force participation rate bounced back to be close to an all-time high of 68.6% with the consequence that in the absence of strong net migration flows, there is little more that can be squeezed out of the labour market in the short term. Effectively, New Zealand has full employment as measured in economist's terms, while participation rates remain at historically high levels.

The Budget projects employment growth will slow slightly over the coming year and then expand modestly by about 1% per annum thereafter. Unemployment is expected to rise slightly and stabilise at around 4.5% out to 2011. This is a little more pessimistic than the forecasts outlined in the table below.

However, despite what looks like a buoyant labour market, this has not been matched by labour productivity growth. In fact, the latest figures available from Statistics NZ make rather depressing reading.

In the year to March 2006 labour productivity grew by only 0.7%. This compares with growth of 2.1 percent for 2005 and an annual average of 2.2 percent between 1993 and 2006. Low growth for the March 2006 year, one of the lowest growth rates ever recorded, was arguably driven by relatively weak output growth of 1.4% and sustained employment growth over the period. Putting aside issues surrounding measurement problems and the fact that the 'measured sector' only accounts for about two-thirds of the economy, the results are clearly a wake up call for both policy makers and businesses alike.

Annual labour productivity growth averaged 2.5% in the measured sector from 1988 to 2006 although to be fair, these averages could be considered to be slightly inflated due to significant restructuring (labour shedding in the late 1980s and early 90s) when employment growth was substantially negative and output growth was also negative for a period.

There are a number of theories floating around at the moment to try and explain the latest low labour productivity figures. One theory is that utilisation of capital capacity falls as demand slows, leading to a fall in output growth. Another arguable cause is that a change in the skill composition of the employed labour force, due to skill shortages, may reduce the average productivity of the labour force. This is possible given the very low unemployment rate and record high labour force participation rates for 2006. Other theories include the possibility of labour hoarding i.e. employers reluctant to dismiss staff for fear of facing the significant transaction costs of recruiting new staff as the economy picks up.

While there is likely to be an element of truth in all the above theories, perhaps the most concerning fact is that over recent years New Zealand's productivity record has continued to be mediocre with labour productivity averaging just over 1% for the past five years. The trend line is clearly downward. This suggests that the above "short-term" theories are not valid when productivity is measured over the longer term. Therefore, with no one factor or policy likely to be a silver bullet in lifting labour productivity, a range of factors must be looked at both from a government level with regulatory policies, and at the individual and firm level, particularly through skills enhancement.

Forecasts: Unemployment % (HLFS)

	Years Ending		
	Jun 07	*Jun 08*	*Jun 09*
Highest	3.9	4.2	4.3
Average	3.8	4.0	4.0
Lowest	3.6	3.7	3.7

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

1.5 Interest Rates (90-day bill rate) – continuing to climb

Most recent outcome: 8.08% as at May 29, 2007

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). As some in the market expect the Reserve Bank to increase the OCR next week, it is likely that there will be more upward pressure on rates.

Many households coming off lower fixed rate mortgages and refinancing will notice a substantial change in mortgage rates with floating rates higher than 10%, while fixed term rates hover around 9%. These are substantial movements compared to a few months ago and will start to bite given that average household debt exceeds 160% of disposable income.

While the forecasts below point to significant reductions in interest rates by 2009, this is not a forgone conclusion. Unless, household consumption is brought under control and the housing market cools significantly, there is every possibility of interest rates remaining high for some time. This is further complicated by the fact that when the NZ dollar drops (as every forecaster has said it will do – sometime), then the potential exists for imported inflation to enter the equation, with obvious consequences for interest rates as the Reserve Bank attempts to keep inflation within its target range over the medium term.

Forecasts: Interest Rates (90 day bills)

	As at End of		
	Jun 07	*Jun 08*	*Jun 09*
Highest	8.2	8.2	6.7
Average	8.1	7.7	6.3
Lowest	8.1	7.2	5.9

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

1.6 Exchange Rates – The random walk continues

Most recent outcome: *NZD = US$0.72.67 as at 29 May 2007*
NZD = AU$0.8919 as at 29 May 2007
TWI = 69.8 as at 29 May 2007

The NZ dollar continues to rise after spending the first half of 2006 tracking downwards. The TWI is now back at levels experienced in early 2006, while the NZ$:US$ shows a similar trend. Predicting exactly where the New Zealand dollar will head over the short term is akin to a random walk, especially when most analysts expect a significant fall in the NZ dollar – but the timing is highly-debatable.

In the very short term, there is likely to be upward pressures on the dollar with the possibility of further interest rate rises on the back of continued strong growth in retail spending, household consumption, and significantly higher milk-payouts for dairy farmers all adding to inflationary pressures on land and house prices – if not on prices across the spectrum.

Despite the recent rise in the NZ dollar compared to our major trading partners, forecasters have continued to predict significant declines in the NZ dollar over the medium term. Treasury, in the recent Budget, considers that the TWI will drop steadily to sit at around 54 cents on the TWI by 2011. This is very much in line with the forecasts outlined below.

AUD (cents)			
	Jun 07	*Jun 08*	*Jun 09*
Highest	0.91	0.868	0.78
Average	0.888	0.828	0.773
Lowest	0.877	0.772	0.763

USD (cents)			
	Jun 07	*Jun 08*	*Jun 09*
Highest	0.750	0.710	0.610
Average	0.740	0.655	0.573
Lowest	.730	0.610	0.540

TWI			
	Jun 07	*Jun 08*	*Jun 09*
Highest	73.0	68.3	60.5
Average	71.8	64.4	57.9
Lowest	70.7	59.5	55.2

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). Secondly, it provides an indication of the likely strength of competition from Australian sourced products on the domestic market.

Despite moves by the Australian Prime Minister, John Howard, to appeal to a disgruntled electorate through tax cuts and spending sweeteners in the latest Budget, his Government is under pressure. However, a generally expansionary fiscal policy and the easing of inflationary pressures suggest the next election may be held in a climate of declining interest rates, which may help the current government's re-election chances.

2.1 Economic Growth (GDP)

Most recent outcome: +2.4% for the year-ended December 2006.

Forecast 2007: +3.0
Source: *The Economist*

Australia's annual GDP increased to 2.4% for the December 2006 quarter, up from 2.1% in the year to September. Forecasts point to increases in growth, with a growth rate of 3% for 2007 increasing to 3.2% in 2008.

Some key recent economic statistics:

- Real retail sales up 6.9 in March 2007 compared with March 2006.
- New motor vehicle sales up 9.6% for March 2007 compared with March 2006.
- Manufacturers' sales up 1.0% for March 2007 compared to March 2006.
- Dwelling unit approvals down 2.2% for March 2007 compared to March 2007.
- Employment up 2.8% for March 2007 compared to March 2006.
- Unemployment rate of 4.5% as at April 2007 – down from 5.0% in April 2006.
- Company profits before tax up 9.0% for the December quarter 2006 compared to December 2005.

The latest Australian PMI results (April 2007) show that Australian manufacturing is currently behind New Zealand's activity levels. The PMI is currently at 51.7 (seasonally-adjusted). Manufacturing activity has slowed reflecting weaker exports, patchy domestic demand and import competition.

2.2 Headline Inflation

Most recent outcome: +2.4% for the year-ended March 2006

Forecasts:
- Mid 2007: 2.6%

Source: *The Economist*

Inflation in Australia has recently dropped after reaching a peak of 4% for the year to June 2006, which included the impact of increasing fuel prices and a sharp rise in the price of bananas in the wake of cyclones.

After holding interest rates at 5.25% for a long period of time, the Reserve Bank of Australia (RBA) lifted the cash rate to 5.5% in March 2005 and has subsequently moved it up three further times; including the most recent increase on November 8 2006. This has meant the cash rate currently stands at 6.25%. However, during subsequent meetings, the RBA has decided to keep the cash rate unchanged.

Part 3: Rest of the World

The economic picture in the rest of the world is very important for New Zealand. Over recent quarters, growth in the world economy has picked up, which will lift demand for New Zealand products and commodities.

United States

America's Federal Reserve continues to hold its benchmark interest rate at 5.25%, extending its pause for ten months after two years of step-by-step tightening. The Fed continues to view the economy as likely to expand at a moderate pace and in its latest statement gave no hint of future cuts. It reiterated that inflationary pressures should ease but said the risk they might not remained its "predominant policy concern".

US GDP grew at an annual rate of 2.1% in the March 2007 quarter, despite a sharp fall in residential investment, which was more abrupt than most had anticipated. The cooling in housing may in fact leave room for one to two 25 basis point cuts in the Fed benchmark interest rate later.

Other data shows manufacturing performing at moderate expansion levels despite cuts in automobile output. Consumer spending is unlikely to fare as well in 2007 as it did in 2006 given the housing market downturn.

American companies, excluding farms, added just 88,000 workers to their payrolls in April, below this year's average of 129,000 a month. Unemployment has edged up slightly to 4.5% in April compared to 4.4% for the previous month and while the health-care industry is in expansion mode, the manufacturing sector has shed jobs.

Real GDP growth is forecast to slow from 3.3% in 2006 to just over 2% in 2007 before recovering to 2.5% in 2008. The US dollar is expected to depreciate further during 2007 with the current account deficit averaging 5.7% of GDP in 2007/08.

Europe

In the Euro area, economic growth indicators are tending to show levels close to historical highs (3.3% for the December 2006 year), which in turn will continue to place pressure on resources and leave inflation pressures high (although inflation in the area is relatively low at 1.8%).

Unemployment in the Euro area edged down to 7.2% in March 2007 compared to 7.5% in December 2006. However, unemployment in a number of Euro countries remains high with unemployment rates for Germany and France being 9.2% (April 2007) and 8.3% (March 2007) respectively.

In Britain, annual growth was close to Euro levels at 2.8%, but is expected to taper off slightly as the year progresses.

Japan

Overall, Japan has tended to be in the doldrums in recent times due to a consumption-led downturn, with both consumer spending and confidence levels pointing downwards. GDP growth currently stands at 2.3%, and is expected to remain around the current rate for both 2007 and 2008.

Consumer prices in Japan actually dropped by 0.1% in March 2007. Expectations are for zero growth in prices over the coming year. Other indicators showed industrial production rose by 1.6% for the year to March 2007.

Labour market developments have tended to be positive but containment in terms of wage growth continues. Japan's unemployment rate remains stable at around 4.0%.

China

Economic activity in China is showing no signs of slowing. Latest results show GDP growth at 11.1% over the March 2007 year, with industrial production increasing a massive 17.6%. Given increased output, it is perhaps surprising that inflation has remained at relatively reasonable levels (3.3% currently) and is expected to moderate slightly to 2.7% by 2008.

Forecasts: World GDP Growth (Selected Trading Partners)

Country	*Latest*	*2007*	*2008*
Australia	2.8%	3.0%	3.2%
Canada	2.3%	2.3%	2.7%
Japan	2.3%	2.4%	2.2%
United Kingdom	2.8%	2.7%	2.5%
United States	2.1%	2.1%	2.7%
Euro Area	3.3%	2.4%	2.1%

Source: Economist

Forecasts: World Consumer Price Inflation (Selected Trading Partners)

Country	*Latest*	*2007*
Australia	2.4%	2.6%
Canada	2.3%	1.9%
Japan	-0.1%	0.0%
United Kingdom	3.1%	2.3%
United States	2.8%	2.4%
Euro Area	1.8%	1.9%

Source: Economist