BUSINESS NZ

PLANNING FORECAST

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BusinessNZ

NZ economy performing despite ongoing global jitters

Executive Summary

Despite ongoing global jitters, the NZ economy continues to improve as evidenced by a number of forward looking economic indicators.

Yes – international commodity prices have come off their recent highs and the volatility of the NZ dollar against the US (as markets factor in the various announcements, both positive and negative, coming out of the United States and Europe) is affecting exporter confidence. However, both actual and forward looking data show the NZ economy is proving to be relatively resilient to international events, assisted to some extent by the relative strength, to date, of our major trading partners – Australia and China.

Both the manufacturing and agricultural sectors are showing relatively strong growth, a statement supported by sentiments expressed in recent survey results, including the BNZ – BusinessNZ Performance of Manufacturing Index (PMI), and the latest Federated Farmers New Zealand Confidence Survey (July 2011).

High commodity prices have not been restricted to dairy products but have applied across the board generally. This bodes well for stronger regional growth as farmers begin to reopen their wallets having to date been largely engaged in reducing massive debt burdens. A softening in world commodity prices of late and the US dollar's continuing volatility may impact on farm-gate returns but it is far too soon to suggest that Fonterra might peel back its projected payout for the 2011/12 season. In fact, Fonterra recently confirmed no change to its opening season forecast payout for 2011/12 of $7.15 - $7.25 before retentions.

Domestic and household confidence is slowly building on the back of an improving labour market outlook, with some evidence that consumers are also starting to reopen their wallets as reflected in recent retail sales and electronic transactions data. The Rugby World Cup will give the service sector a boost over the next couple of months while the flow-on effects could be considerable, as a recent Reserve Bank analysis suggests.

On the government front, Moody's credit rating agency still has NZ on notice of a credit rating downgrade if the country does not sort out its ballooning deficits and mounting government debt.

While Moody's has commended New Zealand's flexible and market-orientated economic policies as a key factor in supporting a stronger economy less prone to external shocks, the country must, over time, address its fiscal deficits and the resultant upward trend in government debt ratios. Hard choices must be made in the next year or so in respect to the big expenditure items such as NZ Superannuation, while it will also be necessary to deal with low quality expenditure and middle-class handouts, not simply tinker with them, as happened with the last Budget.

HIGHLIGHTS

BusinessNZ's Economic Conditions Index (ECI) sits at 19 for the September 2011 quarter, up 4 from the previous quarter and up 32 on a year ago.

International markets remain volatile, underpinned by continuing high levels of debt, which are impacting on investor confidence. However, the outlook for NZ's major trading partners, including Australia and China, while under some pressures of late, still remains relatively healthy.

While there have been some reductions in world commodity prices of late and ongoing volatility in the NZ/US cross rate, NZ continues to have relatively favourable terms of trade.

Both business and consumer confidence are holding up relatively well with households continuing to focus on debt reduction, while the economy will get a shot in the arm from the Rugby World Cup and the ongoing rebuild of Christchurch.

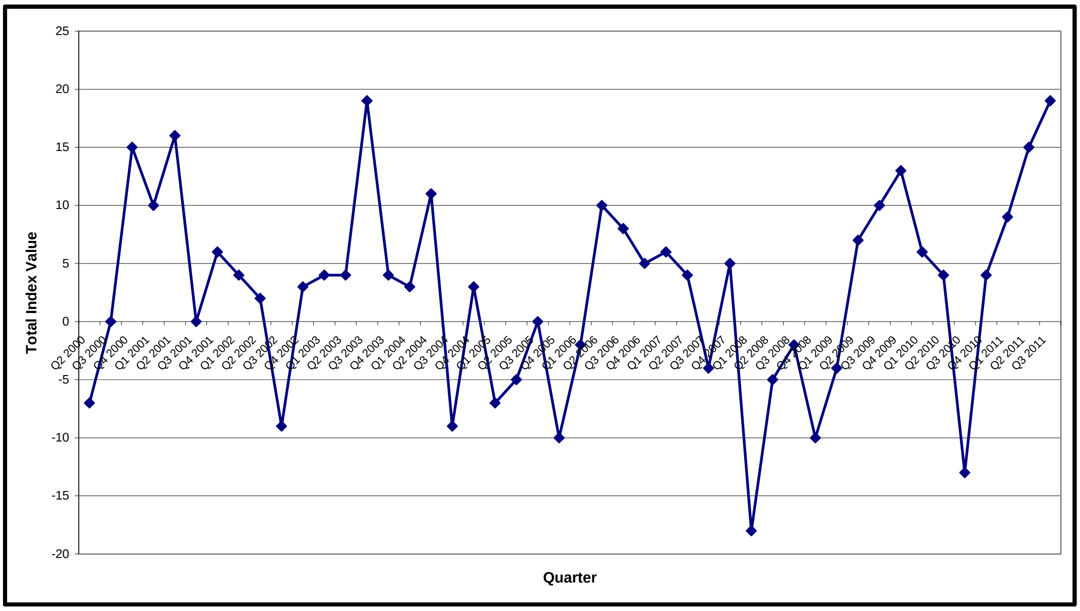
Consumer confidence is likely to rise further as the labour market continues to improve, while the prospect of a delay in interest rate rises will further boost confidence. However, inflationary pressures remain a concern.

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 19 for the September 2011 quarter, up 4 from the previous quarter and up 32 on a year ago.[1]

Overall Economic Conditions Index (ECI)



Source: BusinessNZ

Data in the ECI is broken into four key sub-groups:

- Economic growth/performance indicators
- Monetary policy/pricing indicators
- Business/consumer confidence indicators
- Labour market indicators

In terms of the ECI sub-groups:

<u>Economic growth/performance indicators</u> sit at 4 for the September 2011 quarter, the same as the last quarter but up 6 on a year ago. Despite commodity prices coming off their recent highs, NZ has its best terms of trade (a measure of the price of exports compared to imports) for 37 years.

<u>Monetary policy/pricing indicators</u> sit at 1 for the September 2011 quarter, down 1 on the last quarter but up 9 on a year ago. Despite rising inflationary pressures in some quarters, previously signalled interest rate rises, intended to move monetary policy to a more neutral setting, are likely to be delayed due to a high NZ dollar and continued uncertainty over international growth prospects.

[1] 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.

<u>Business/consumer confidence indicators</u> sit at 9 for the September 2011 quarter, up 2 on the previous quarter and up 12 on a year ago. Both business and consumer confidence indicators remain remarkably resilient in light of ongoing global uncertainty.

<u>Labour market indicators</u> sit at 5 for the June 2011 quarter, up 3 on the previous quarter and up 5 on a year ago. Recent official data show small employment gains, while forward looking indicators project both relatively strong employment growth and modest reductions in unemployment over the next two years.

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

1.1. Economic growth (GDP) – outlook still positive despite risks

Despite recent concerns about the global economic outlook, New Zealand can still look forward to growth of around 4% for 2012, moderating slightly in 2013, as outlined in the forecasts below.

Forecasts: Real GDP % Growth

	Years Ending		
	Sep 11	Sep 12	Sep 13
Highest	2.9	4.7	4.2
Average	2.1	4.0	3.4
Lowest	1.7	3.5	3.0

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

Growth of 0.8% for the March quarter 2011 was much higher than market expectations, given that the quarter included the February 22 Christchurch earthquake and its aftermath. There is a large amount of data supporting relatively strong growth as measured by a number of reputable surveys, the effects of the earthquake notwithstanding.

International commodity prices, while taking a breather of late, are still at elevated levels by recent historical standards. NZ's trade balance remains in the black after continued strong demand from China, while the still relatively favourable exchange rate with Australia is encouraging exports into that market. The trade balance for the July 2011 month was a surplus of $129 million, the first July surplus since 1991. Increasing export value was led by milk powder, butter and cheese and crude oil exports.

The trend in the value of exports has increased 30% since its most recent low point in October 2009, and continues to reach new heights. On the import side, the trend value is up 20% since the most recent low point in September 2009, but is still significantly (9.9%) below its overall peak in September 2008.

The ANZ Commodity Price Index stands at 304.3, down marginally from a month earlier (and the third month in a row showing some fall). However, the index is still a healthy 22% up from a year ago. When converted into NZ dollars, with the impact of exchange rates taken into consideration, commodity returns are now a little more subdued. The index is steady at 200.3 but still up 6% on a year ago. However, it is significantly off its high of 225.6 reached in March this year.

Despite recent drops in commodity prices, the figures need to be put in perspective. On a historical basis they are still extremely high and underpin NZ's best terms of trade in 37 years.

ANZ Commodity Price Index

	World Price Index	NZ$ Index
Aug 2007	240.5	188.0
Aug 2008	248.0	198.7
Aug 2009	190.5	155.6
Aug 2010	249.1	189.1
Aug 2011	304.3	200.3

Source: The ANZ

Domestically, a number of generally one-off events will impact strongly on growth for the remainder of this, and into next, year – namely the Rugby World Cup and the rebuild of Christchurch. Analysis by the Reserve Bank suggests that the Rugby World Cup will have a significant impact on growth while estimates of the costs and resources going into the rebuild of Christchurch seem to increase continually as time goes by. By any analysis, the numbers are large.

Despite the above positive factors for growth, there are also risks which have to be factored in.

The global outlook is uncertain at present, largely driven by unsustainable levels of debt in many developed countries and the need for substantial reform, not band-aid tinkering as has been the case to date. In simple terms, risk makes markets nervous and necessarily requires a greater return on investment to compensate. Current market nervousness is also reflected in exchange rate volatility, affecting global currencies, not just the NZ dollar.

NZ is still exposed to relatively high levels of international debt, although the Government portion, while it has risen reasonably rapidly of late, is still relatively low compared with some other countries. The danger is the potential for a credit rating downgrade; with obvious consequences for interest rates should the Government not get its fiscal deficit under control in the next couple of years.

While evidence suggests that the Government is still on track to return to surplus by 2015, the need to seriously address major expenditure items will be ongoing and not able to be avoided. Nor will it be possible simply to portray some policies as non-negotiable, as appears to be the case with, for example, NZ superannuation.

NZ has been held up by Moody’s credit rating agency as having flexible and market-oriented economic policies, including sound fiscal management and monetary polices. This is true but needs to be backed up by equally sound regulatory polices.

In this respect, it is pleasing that after a long gestation period and extensive analysis, the Regulatory Standards Bill has finally been introduced into Parliament with submissions currently being analysed by the Commerce Select Committee. The aim of the Regulatory Standards Bill is to improve the quality, transparency and accountability of lawmakers but inexplicably, local government regulation has been excluded from its ambit.

The exclusion of local government regulation from the requirements of the Regulatory Standards Bill is assumed to be based on the premise one step at a time, with the possibility of including such regulation at a later time. But the exclusion is problematic.

Local government has extensive powers under various Acts, including the Local Government Act 2002, the Waste Minimisation Act 2008 and the Resource Management Act 1991. While these regulatory powers are, in general, likely to be used constructively, there are numerous possibilities for potentially inappropriate use, with major implications such as raising the cost of doing business and reducing market competition. These are good reasons for recommending that the Regulatory Standards Bill apply equally to local government regulation.

1.2 Monetary Conditions – pressure still building

Interest rates – rise inevitable but some delay?

The 90-day bill rate is forecast to increase slowly and reach 5 percent by June 2013 as evidenced in the forecasts below.

While the Official Cash Rate (OCR) was reduced 50 basis points to 2.5 percent as a direct result of the Christchurch earthquake, interest rate rises can increasingly be expected for a number of reasons.

First, and perhaps most importantly, current interest rates are at what could be described as an artificially low level when compared with long-run averages over the last decade or so. Therefore a move back to more neutral levels is to be expected as the economy gathers momentum.

Second, the strength of the economic upswing is perhaps slightly on the upside of expectations, despite global growth jitters.

Third, an improving labour market will see greater pressure on wage-bargaining than has been the case over recent years. Pockets of inflationary pressure are likely to develop as a result of the Christchurch rebuild, particularly given the enormity of the task, while competition for skilled tradespeople from Australia is also likely to be an ongoing issue.

Fourth, a slow down in world commodity prices should (eventually) take some pressure off imported oil and domestic food prices although the most recent data on food costs is not looking good with large increases still evident.

Fifth, businesses and consumer expectations are for interest rate rises. The National Bank's Business Outlook (August 2011) shows that a net 82% of firms expect the OCR to rise over the next 12 months, up significantly from the 59% in the previous survey.

Finally, a credit rating downgrade for NZ, although unlikely at this stage, would likely result in upward pressure on interest rates given the country's reliance on foreign capital.

On the other hand, there are other pressures that are likely to keep inflationary pressures largely under control.

First, the reasonably sustained strength of the NZ dollar (although still volatile) should help subdue any hint of imported inflationary pressures.

Second, a net external outflow of migration (mainly to Australia) will remove pressure on the housing market, although this could be a two-edged sword if an improving labour market puts significant upward pressure on wage rates.

In sum, inflationary pressures are finely poised although as mentioned earlier, NZ's current loose monetary policy will not be sustainable over the medium term. Some tightening is inevitable. The issue for the Reserve Bank is simply the timing of interest rate hikes. All in all it is a particularly difficult time to be Governor of the Reserve Bank given the numerous upward, and potentially downward, pressures on inflation operating all at the same time.

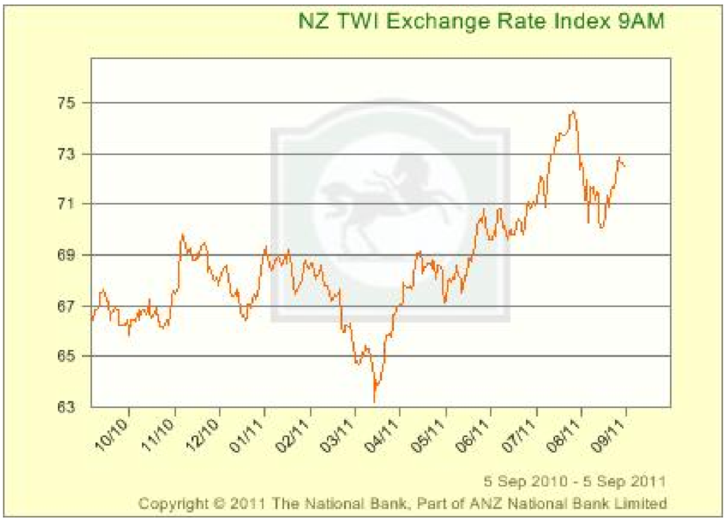
Forecasts: Interest Rates (90 day bills)

	As at end of		
	Sep 11	Sep 12	Sep 13
Highest	3.1	4.7	5.7
Average	2.9	4.4	5.0
Lowest	2.8	4.0	4.2

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

The New Zealand dollar – a dollar each way but likely upward bias!

Forecasts below show the NZ dollar, on a trade-weighted-Index (TWI) basis, is expected to stay relatively constant out to June 2013 although forecast, potentially, to fluctuate wildly against the US dollar, as evidenced by the range of responses below.



Focus by some media commentators of late has been on the $NZ/US cross rate. This does not necessarily provide a good overall picture of the economy since the US economy is still in deep trouble and many investors are moving to other currencies, including NZ's, where future prospects are considerably better. Nor is it just the NZ dollar that is showing volatility against the $US; other currencies are being hit as well. The current volatility is largely a US story and does not indicate something fundamentally wrong with NZ.

But although the dollar's volatility, as investors to-and-fro in their support for the US dollar, is a US story, that volatility nevertheless causes difficulty for a number of NZ exporters heavily dependent on trading in US dollars. Planning with any future certainty is fraught with what ifs.

Of course there is not much we can do about the weakness of other countries' currencies, but could we intervene in our own currency to slow its rise or its volatility? Some suggestions put forward by various people have included currency controls, Tobin taxes, core-funding ratios and other methods. While some of these may have potential in temporarily stabilising currency movements, they all have significant downsides. Unfortunately, none of them can bring currency stability without at the same time increasing interest rates, reducing necessary liquidity or doing damage somewhere else in the economy.

Does that mean we can do nothing about this situation which is depleting returns to our exporters? In fact, there are some solutions – but they are not an instant fix. First, we could seek to make our economy as competitive as it can, thereby allowing New Zealand exporters to be as competitive as they can. This is important because a high currency brought about by a competitive, high-value, high-functioning economy is a very different thing from a currency that is only high in comparison with a weak $US. So making our economy as competitive as possible is a major issue. Competitiveness comes down to innovation and productivity. Innovative products and services means we can become price makers, not price takers. And productivity greater than other countries allows us to earn comparatively more.

Notwithstanding the above, the future direction of the NZ dollar is very uncertain with potentially further upward pressures, particularly against the US dollar.

Strong forecast growth, continuing relatively high commodity prices, and recent rises in input producer prices (a measure of wholesale inflation) will keep the Reserve Bank on its toes in terms of when to lift interest rates. Relatively low interest rates internationally, as governments and central banks try to stimulate demand, could well encourage investors to pour more money into NZ, increasing the upward pressure on the NZ dollar.

Then, too, a relatively weak world economy and particularly weak US prospects may encourage investors to move to commodity-based currencies such as the Zealand dollar as prospects for safe havens reduce. Paradoxically, world market volatility can both encourage and discourage support for the US dollar.

Downside pressure on the dollar will likely be restricted to issues around growth rates and whether or not the current forecast growth rates of 3-4% can be delivered, taking some pressure off the Government in terms of overseas borrowing requirements.

Finally, the implications of any credit downgrade also need to be factored in when considering the dollar's probable future direction.

As stated earlier, the future direction of the NZ dollar is difficult to predict with any degree of comfort. As has been the case over the last few months, the NZ dollar is likely to be in for a wild ride with volatility the order of the day for some time to come, although, for the reasons outlined above, with an upward bias for the medium term against the $US.

Forecasts: Exchange Rates

AUD (cents)			
	Sep 11	Sep 12	Sep 13
Highest	0.815	0.850	0.840
Average	0.801	0.818	0.813
Lowest	0.790	0.800	0.800

USD (cents)			
	Sep 11	Sep 12	Sep 13
Highest	0.880	0.930	0.880
Average	0.865	0.863	0.805
Lowest	0.850	0.790	0.770

TWI			
	Sep 11	Sep 12	Sep 13
Highest	75.2	75.8	73.1
Average	73.9	73.8	70.8
Lowest	72.1	70.7	69.2

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

Inflation - pressures remain

Forecasts outlined below show that inflation will be probably just within the Reserve Bank's target of 1-3% for the year to June 2013 after earlier breaking that band largely as a result of one-offs, including the hike in GST on 1 October 2010.

Several factors are putting upward pressure on inflation with, at the same time, some potential downward pressures.

In terms of upward pressure, first are the flow-on effects of one-offs such as the increase in GST to 15% from 1 October 2011. These effects are continuing to work their way through annual headline inflation (still uncomfortably high) and have the potential to impose further upward pressure given that headline inflation is often inappropriately focused on as a proxy in wage and other contract bargaining.

Second, the demand for labour for the Christchurch rebuild, along with significant competition for labour from Australia, will likely add to inflationary pressures in some parts of the labour market. Furthermore, there is strong evidence that labour market conditions are improving, also likely putting added pressure on wage costs in 2012.

Third, input producer prices, a measure of headline inflation, were 0.9% higher in the second quarter of 2011, the 7th straight increase, with annual gains of 4.8%. The ability to absorb cost increases without passing them on can only continue for so long.

Fourth, consumer and business expectations are for inflation to remain at the top end of the Reserve Bank's target band (1-3%) for the next couple of years. While business and household expectations are not everything, they can have an important influence on behaviour.

Whether reductions in international commodity prices will reduce the pressure on the NZ consumer will largely depend on the future direction of the NZ dollar. To a certain extent, NZ's relatively high dollar, particularly against the US, has sheltered NZ businesses and households from the worst excesses of international price increases over the last year, particularly for food and oil. Provided the NZ dollar doesn't drop rapidly, reductions in international commodity prices will eventually result in lower consumer prices. Unfortunately this is a double-edged sword as NZ commodity producers will then face the real prospect of lower incomes with, for example, Fonterra potentially lowering its forecast payout to dairy farmers for the 2011/12 season. As economists often say, there is no such thing as a free lunch!

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Sep 11	Sep 12	Sep 13
Highest	5.2	2.8	3.2
Average	5.1	2.3	2.9
Lowest	4.9	1.8	2.6

Source: ANZ, A1.8SB, BNZ, National, and Westpac

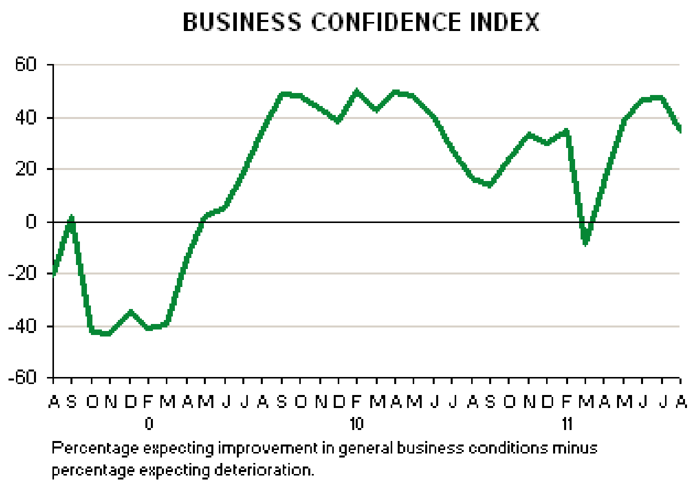
1.3 Business and consumer confidence – consolidating

Business confidence – showing resilience

A number of surveys show business confidence, while bouncing around, is demonstrating real resilience in spite of ongoing global growth concerns. Most surveys show confidence as recovering rapidly after a sharp, but temporary fall in March 2011 due almost entirely to the Christchurch earthquake on February 22. Both the long-standing NZIER Quarterly Survey of Business Opinion (QSBO) and more recently, the National Bank's Business Outlook (August 2011) indicate that confidence continues to be sustained at relatively high levels in spite of global pressures, including volatility in the NZ dollar.

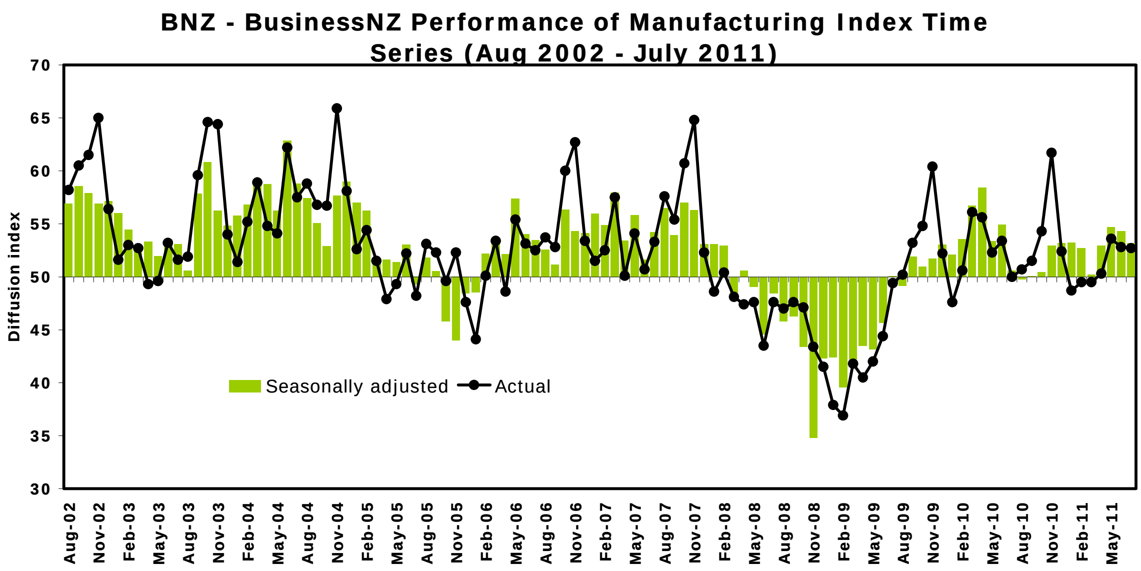
The National Bank's Business Outlook (August 2011) shows that a net 34% of businesses expect better times for the economy over the coming year, down 13 points on July. However, of much more importance, businesses' own activity expectations have shown resilience. A net 43% of businesses expect better times ahead for their own business, essentially the same level as the previous month. This is well above the historical average of +26. Own activity sentiment was up in four of the subgroups (retailing, agriculture, construction and services) but down in manufacturing.

National Bank Business Confidence Index



The one cautionary tone is not surprisingly reflected in export intentions with recent global volatility and wild currency swings impacting on export confidence with export intentions having slipped from a net 31% expecting to lift volumes to a net 19%. While still reasonably positive, this is the lowest reading for export intentions in two years.

Resilience in business confidence is also being reflected in a more consistent improvement in the manufacturing sector. The latest BNZ-BusinessNZ Performance of Manufacturing Index (PMI) shows manufacturing activity continuing to pick up.

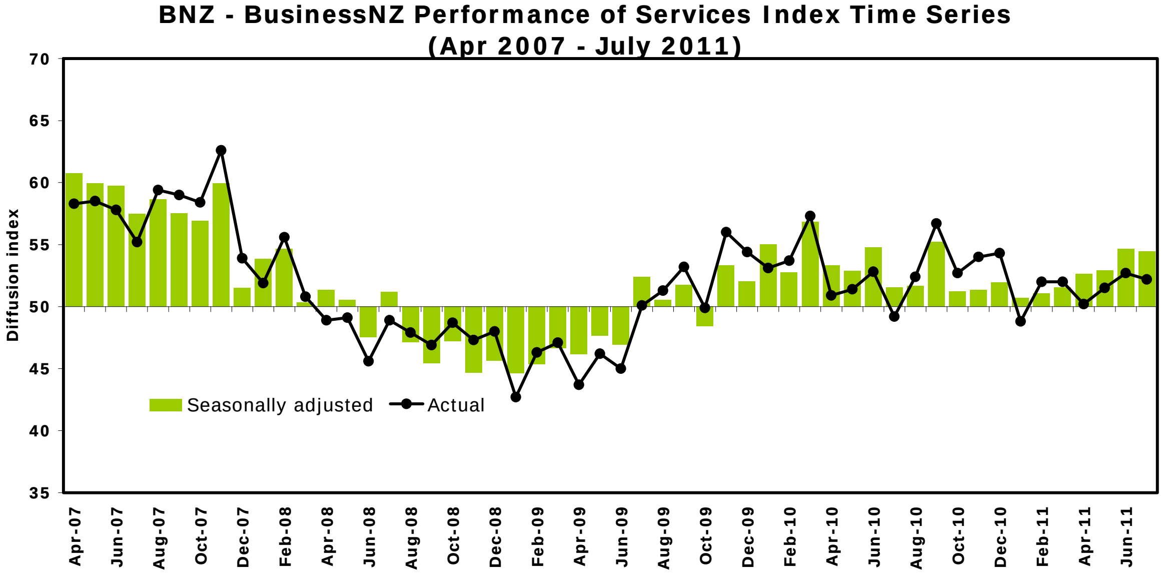


Source: BusinessNZ

The PMI (seasonally-adjusted) for the month of July 2011 was 53.2. A PMI reading above 50 points indicates manufacturing activity is expanding; below 50 indicates it is contracting. The PMI has been in expansion mode since August 2010 when it just dipped below 50. All five seasonally adjusted indices which make up the overall PMI were in expansion during July. Encouragingly, *new orders* (56.0) led the way for the second consecutive month, followed by *deliveries* (53.7) and *employment* (52.2), which reached its highest result since March 2011. *Production* (51.8) slipped 0.6 points from June, while *finished stocks* (50.7) went back into expansion for the first time since April 2011.

The seasonally adjusted BNZ-BusinessNZ Performance of Services Index (PSI) for July 2011 (54.5) was down 0.2 points from June. Nonetheless, it represented an ongoing and steady level of expansion for the second month running, as well as being the highest July result since 2007 (57.5).

Four of the five sub-indices were in expansion during July. *New orders/business* (58.6) continued its upward trend with its highest result since March 2010, *activity/sales* (56.3) dipped from June but *supplier deliveries* (52.0) recorded its highest value since September 2010. Last, *employment* (48.8) recorded its first decline in employment since January 2011.



Source: BusinessNZ

While the service sector continues to expand overall, particular sub-sectors namely, *accommodation, cafes & restaurants* should get a healthy kick along over the next month or so with the influx of supporters for the Rugby World Cup.

On the agricultural front, confidence remains high despite some slight fall-off in international commodity prices of late. The snow storms in August came and went and had little bearing on overall production given that the lambing and calving seasons are only now getting into full swing. A month later and things might have been different.

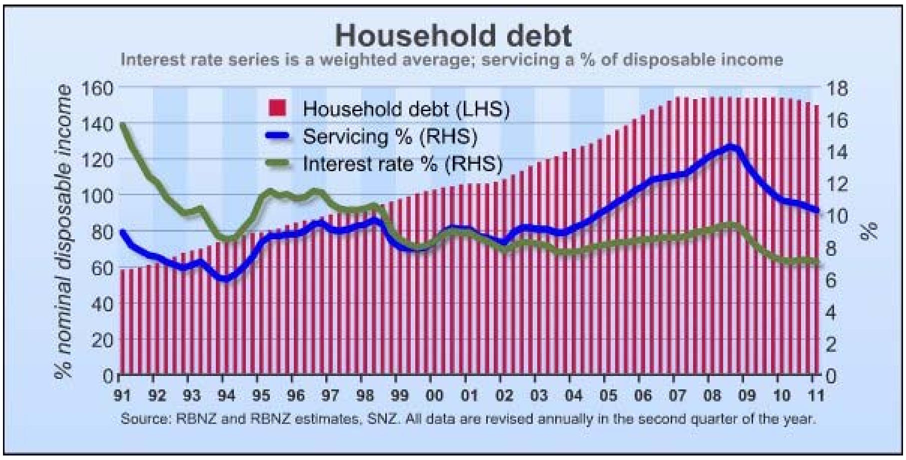
Federated Farmers' bi-annual Farm Confidence Survey (July 2011) shows farmers as much more confident now than they were in January 2011 despite commodity prices coming off their recent peaks and the dollar being at record highs against the greenback.

A net 16.4% of respondents to the Farm Confidence Survey are expecting an improvement in the general economy over the coming 12 months, up 11.6 points on January. Confidence has increased for all industry groups and regions although dairy farmer confidence increased by a somewhat lesser amount than confidence amongst meat and fibre and grain farmers.

Key indicators show positive responses in respect to profitability, production, and expenditure. Not unexpectedly, farmers are still very much focused on debt reduction with a significant increase in the number expecting to reduce debt over the coming 12 months, a net 45.6% compared to a net 25.3% in January. It's simply a case of making hay while the sun shines.

Consumer confidence – creeping up slowly

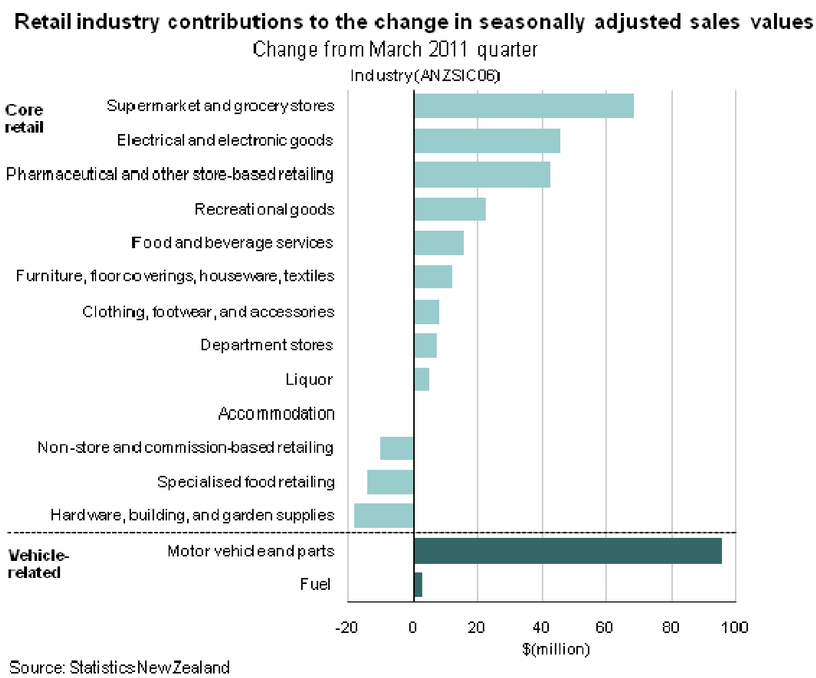
Consumer confidence continues to show modest increases although households are still largely focused on reducing the debt mountain built up over the last two decades.



High levels of household debt remain a concern despite moves over recent times to cap debt expansion. Significant increases in insurance costs in light of the Christchurch earthquake will put added pressure on household budgets. Insurers will likely take a very prudent approach to increasing their exposure over the short to medium term, particularly in respect to building cover, until there is clear evidence that seismic activity has fallen away. This is likely to have an adverse effect on the speed of building redevelopment in Christchurch.

Despite these risks, consumers seem largely indifferent to what is happening in international markets with the ANZ-Roy Morgan NZ Consumer Confidence survey showing confidence rising slowly after taking a one-off hit in the first quarter of 2011. The index rose 3.9 points to 113.3 in August 2011, taking it to its highest level since January. Although the level is still below its historical average of around 118, that confidence is still rising in spite of reasonably turbulent economic times, particularly overseas, is a positive sign.

Paradoxically, turbulent economic times have likely delayed expected interest rate increases, allowing households to continue to focus on reducing debt to more manageable levels; inflationary pressures are also likely to be more balanced than was the case even a month or so ago. Evidence of an improving labour market outlook should similarly boost consumer confidence over coming months, auguring well for a long-awaited expansion in the retail sector, including electronic sales. In fact, recent growth in retail sales gives cause for optimism with the value of total sales increasing 1.7% in the June 2011 quarter following a 2.3% increase in the March quarter. Sales' values increased in all regions with motor vehicles and motor vehicle parts up a healthy 4.2% in the June 2011 quarter.



1.4 Labour market – outlook positive

Employment – encouraging outlook overall but concern about youth

Both official and forward-looking survey data point to a much stronger labour market with forecasts below showing unemployment to be around 4.7% by September 2013.

After very strong growth in employment and associated reductions in unemployment in the first quarter of 2011, both employment and unemployment numbers remained relatively static for the June quarter as measured by Statistics NZ's Household Labour Force Survey (HLFS). The unemployment rate was unchanged at 6.5 percent, following a slight downward revision to the March 2011 quarter rate. However, when one digs a little deeper into the data for the June quarter, there is positive news.

Household Labour Force Survey: June 2011 quarter

Seasonally adjusted	June 2011 quarter	Quarterly change	Annual change
Unemployment rate	6.5%	0.0	-0.4
Unemployed	154,000	-0.1%**	-3.7%
Employed	2,214,000	0.0%	+2.0%
Not in the labour force	1,096,000	+1.4%	+0.3%
Labour force participation rate	68.4%	-0.2	+0.3

Source: Statistics NZ

Hours worked increased 1.6 percent, a good leading indicator of likely employment growth as businesses seek to maximise hours worked before taking on new staff. Notwithstanding the rise in hours worked, hours per worker are still below historical average rates.

The latest results showing a relatively static picture of employment growth and levels of unemployment need to be taken with a grain of salt. After a very strong March quarter, and expectations of improving confidence from other surveys e.g. the ANZ Jobs Adds series and the Westpac McDermott Miller Employment Confidence Index, it is likely that the September quarter HLFS will show significant growth in employment plus some further reduction in unemployment.

The ANZ Job Adds series shows job advertisements lifting 0.9 percent in July, their sixth month of increases. The lift was driven by a 2.2 percent rise in internet listings, partially offset by a 3.9 percent fall in newspaper advertising.

While the level of newspaper job ads fell, newspaper job ads are 33% higher than at the start of the year and 20% higher than a year ago. Although still at a relatively low level compared to the dizzy heights reached in 2007, the renewed strength in job ads bodes well for future employment growth and an associated decline in unemployment.

Despite the positive employment outlook overall, a significant issue which policy makers need to tackle is the impact of youth unemployment. According to the HLFS, employment fell 2.5% in the 15-19 age group, to be 11 percent lower than 12 months earlier. The youth unemployment rate is now a staggering 27%, the highest in the history of the HLFS. With almost all other age groups showing improving outcomes and relatively low unemployment rates, the youth rate stands out like a sore thumb.

There are likely to be a number of reasons for the high rate of youth unemployment including a general lack of strong attachment to the labour market since many young people may have alternative sources of income (e.g. parents) or do not have dependents, giving them greater flexibility to enter and exit the labour market as they see fit.

While there is no silver bullet, gaining initial attachment to the labour market is an important discipline helping to improve an individual's productivity and hence earning potential over time. A move such as the reintroduction of the youth minimum wage should be but one part of a strategy for addressing what can only be described as an unacceptable outcome to date. Youth unemployment is one of NZ's biggest ticking time-bombs and must be addressed in a comprehensive and systematic manner to avoid subsequent social and economic dislocation.

Forecasts: Unemployment % (HLFS)

	Quarter		
	Sep 11	Sep 12	Sep 13
Highest	6.3	5.5	5.2
Average	6.3	5.3	4.7
Lowest	6.2	4.9	4.0

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

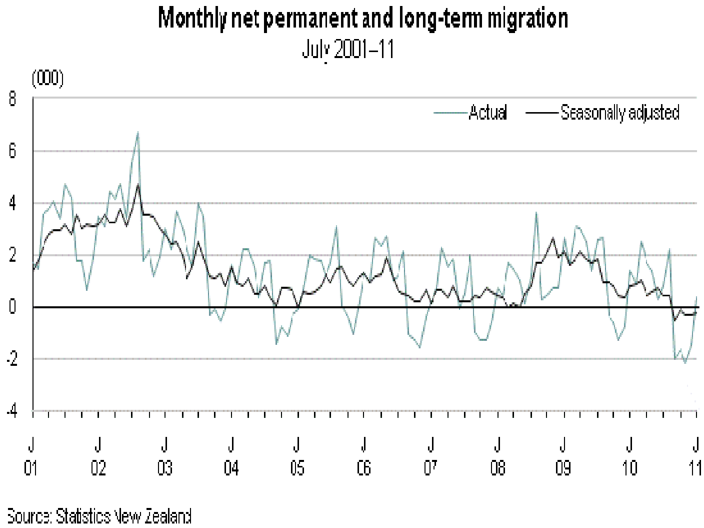
Labour costs – upward pressure to come

Forecasts below indicate that labour costs are expected to increase modestly to around 2.7 percent for the years ending June 2012 and 2013. This is very much in line with the long-run average for the LCI.

Improving labour market conditions with moves towards greater capacity utilisation will likely put upward pressure on wage rates over coming months. Latest official figures show that salary and wage rates (including overtime), as recorded by the Labour Cost Index (LCI), are still relatively subdued, increasing by 1.9% in the year to the June 2011.

There has been anecdotal evidence of an increased threat of industrial action, as some sectors push for relatively high wage increases, given recent wage rise trends. The question remains as to the extent to which such increases, if successful, will generate relativity arguments in other sectors of the economy. A relatively deregulated labour market much reduces the potential for flow-on impacts but the tendency for wage negotiators to base claims on headline inflation, plus a margin, means the likelihood of higher coming wage demands than in the recent past.

An interesting factor in the mix is the potential size of the labour market given that over the last year or so net permanent and long-term migration inflows have continued to drop off with increases in outward migration boosted by some Christchurch residents moving offshore.



For the year ended July 2011, there was a net inflow of 2,867 migrants, which is well below the average annual gains of 12,000 for the years ending 1991-2010. The net loss of migrants to Australia is still a major issue with a net loss of 31,600 in the July 2011 year, the highest since the April 2009 year (32,000). To put these figures in context, outflows to Australia represent Wellington's Westpac Stadium at close to full capacity! The potential flow-on impacts of a lower labour pool could well result in increased wage and salary pressures, particularly, in those areas where there are skill shortages or where people have significant options, including overseas offers of employment.

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

	Years ending		
	Sep 11	Sep 12	Sep 13
Highest	2.2	3.7	3.8
Average	2.1	2.7	2.7
Lowest	2.0	2.0	2.0

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