BUSINESS NZ

PLANNING FORECAST

MARCH 2015

BusinessNZ

NZ Economy – balancing risks

Executive Summary

While one can roll off a number of risk factors facing the NZ economy, currently there are also significant opportunities. Overall risk appears finely balanced, auguring well for growth of around 3% over the forecast period.

On the positive side, construction is still firmly in the driving seat (and will be for some time), the manufacturing sector remains on solid ground and there is continuing growth in the services sector. The agricultural sector is still a mixed bag. The impact of the drought is yet to filter through although there has been a tendency for farmers to offload stock earlier than usual to mitigate feed shortages.

Investment intentions have stayed relatively strong as evidenced by a number of business opinion surveys and employment growth is also relatively strong. Headline employment growth has not been matched by a reduction in the official unemployment rate simply because the labour force participation rate is now at an historic high (more on this under the Labour Market section).

Inflation is firmly under control with lower international commodity prices keeping a lid on input costs, helped along to some extent by an elevated exchange rate and relatively strong competition on the domestic front. Overall, producer prices remain subdued both in terms of inputs and outputs.

Any movement in interest rates (either up or down) appears likely to be minimal over the next year or so with the Reserve Bank giving a clear signal that the Official Cash Rate (OCR) will probably stay at current levels for an extended period of time (barring unforeseen circumstances).

On a gloomier note, while Global Dairy Prices have recovered some of the ground lost over the last few months, the latest results (a substantial dip) give cause for concern. The dip is likely to be partly a consequence of this year's production not being as bad as previously forecast. The next couple of GlobalDairyTrade (GDT) auctions will be looked at with interest as any significant further reductions will likely lead to a cut in Fonterra's forecast payout.

Strong net inward migration is somewhat of a two-edged sword. While population growth will ramp up demand, it comes at a potential cost of greater inflationary pressure, particularly in respect to Auckland housing. Given such pressure, the Reserve Bank is likely to continue with its LVR regime for some time to come.

New funding mechanisms such as peer-to-peer lending platforms (Harmoney, for example) may be a way of trying to get around tighter Reserve Bank lending controls on traditional bank mortgages. Time will tell whether there is a gap in the market for such new financing options, particularly in the mortgage market and with regard to the general consolidation of debt.

HIGHLIGHTS

The BusinessNZ Economic Conditions Index (ECI) sits at 17 for the March 2015 quarter, up 5 on the previous quarter and up 9 on a year ago.

The NZ economy continues to perform at solid levels with upside and downside risks currently finely balanced.

The BNZ - BusinessNZ Performance of Manufacturing Index (PMI) and the Performance of Services Index (PSI) show continued significant growth in both key sectors, while other sectors, particularly construction, are also showing significant activity.

While sentiment in the agricultural sector is still mixed with the effect of the drought yet to be factored in, global commodity prices appear to be recovering despite the most recent blip in the GlobalDairyTrade (GDT).

Business and consumer confidence remains solid and investment intentions are firming.

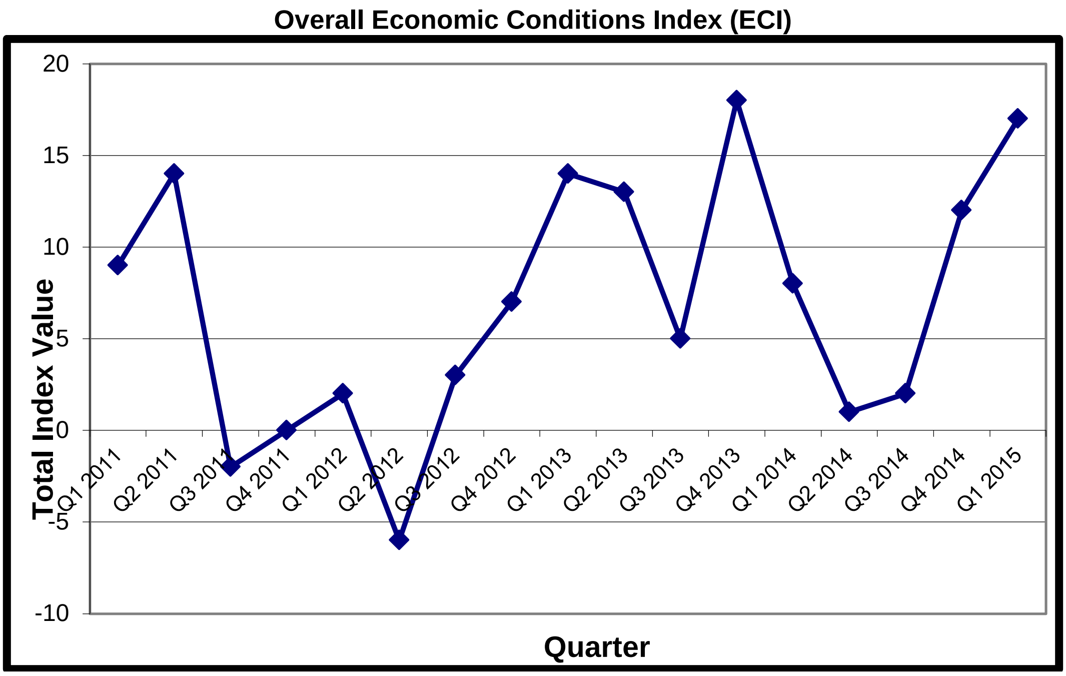
Inflation is dead for the moment with low interest rates firmly cemented in place despite continued pressure from the housing sector.

Employment growth is solid while the official unemployment rate is taking time to drop - almost solely due to a much higher labour force participation rate.

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 17 for the March 2015 quarter, up 5 on the previous quarter and up 9 on a year ago.[1]



Source: BusinessNZ

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

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

Of the ECI sub-groups:

Economic growth/performance indicators sit at 3 for the March 2015 quarter, down 2 on the last quarter and down 3 on a year ago. Significant reductions in commodity prices, particularly dairy, are being reflected in NZ's lower terms of trade with Fonterra's GlobalDairyTrade (GDT) auction showing fluctuating fortunes of late.

Monetary policy/pricing indicators sit at 5 for the March 2015 quarter, up 3 on the last quarter and up 9 on a on a year ago. Inflationary pressures are largely absent with the prospect of low interest rates for the foreseeable future.

Business/consumer confidence indicators sit at 5 for the March 2015 quarter, up 2 on the previous quarters and up 9 on a year ago. Business and consumer confidence is firmly in positive territory, as reflected in a number of key forward-looking indicators.

Labour market indicators sit at 4 for the March 2015 quarter, up 2 on the previous quarter and the same as a year ago. The official labour force participation rate (as measured by the Household Labour Force Survey (HLFS)) is at a record high, boding well for future employment growth. Both the BNZ-BusinessNZ Performance of Manufacturing (PMI) and Performance of Services (PSI) Indexes show relatively strong employment growth.

[1] The ECI tracks over 30 indicators on a quarterly basis. The overall index value for any particular quarter represents the net balance of the indicators (generally the number increasing minus the number decreasing) thus providing an overall measure of performance. In general, increases in an indicator are seen as positive (e.g. growth in GDP or employment) and declines as negative. However, this is not always the case. For example, declines in unemployment are seen as positive and increases as negative.

PART 2: THE NEW ZEALAND ECONOMY – WHERE ARE WE GOING?

1.1 Economic growth (GDP) – solid performance at around 3%

Forecast growth of around 3 percent per annum out to March 2017 (see below) is pretty well cemented in with the strong growth in construction still the key driver. (The construction sector is currently growing at an extraordinary 13% per annum).

Other key forward-looking indicators point to solid growth as evidenced by the ANZ Truckometer, a measure of economic activity using real-time traffic data.

Forecasts: Real GDP % Growth

	Years Ending		
	Mar 15	Mar 16	Mar17
Highest	3.3	3.0	3.3
Average	3.3	2.8	2.7
Lowest	3.2	2.6	1.5

Source: ANZ, ASB, BNZ, and Westpac

The BNZ - BusinessNZ Performance of Manufacturing Index (PMI) and the Performance of Services Index (PSI) show activity/sales staying at elevated levels.

The agricultural sector continues to face mixed fortunes and the impact of the drought conditions is yet to be fully factored in, although the early disposal of stock will no doubt be reflected in slightly lower growth for mid-2015 than might otherwise be the case.

Fonterra's GlobalDairyTrade (GDT) auction recently fell significantly after six consecutive price rises with some early indications that milk production may not be affected as much as earlier forecast. This may mean that buyers are more confident that supply will remain at relatively high levels. On the other hand, increasing demand for quality protein will likely force up prices in the second half of this year.

Ultimately, the only real certainty is the uncertainty prevailing both internationally and domestically. Businesses and indeed households must increasingly manage a number of risk factors which in the past would have been considered one-offs or would not have fallen within the realm of rational possibilities.

In the international context these include, but are certainly not limited to:

- The process of moving towards more sustainable monetary policy regimes in key international markets (particularly the US and Europe)
- Potential international deflation and its impact on incentives to invest (who would have thought of negative interest rates 10 year ago!)
- The containment of Ebola
- Middle East extremist factions
- Food quality/integrity (product assurance through secure supply chains)
- World demand – most developed countries are still in a slow recovery phase, while NZ's major trading partner, China, has slowed down of late
- Australia's continued economic malaise

Domestically, risks include:

- A continuing elevated $NZ (particularly for exporting firms)
- High levels of both household and agricultural debt increasing vulnerability
- Impact of drought conditions on agricultural production and capital stock numbers
- The potential impact of uneven growth throughout NZ with growth rates quite diverse depending on the particular region
- Potential political threats to the Government's ability to proceed with key regulatory reforms such as of the Resource Management Act (RMA), and more generally in the area of improving overall regulatory quality.

All the above factors combined have the potential be make forecasting future growth prospects extremely difficult.

1.2 Monetary Conditions – no change

Interest rates – stable

The 90-day bill rate is forecast to increase slightly over the forecast period to reach 4.1 percent by March 2017 (see forecasts below).

Forecasts: Interest Rates (90 day bills)

	As at end of		
	Mar 15	Mar 16	Mar17
Highest	3.7	3.8	4.3
Average	3.7	3.7	4.1
Lowest	3.7	3.7	3.7

Source: ANZ, ASB, BNZ, and Westpac

The Reserve Bank has come out in its latest Official Cash Rate (OCR) review more or less implying that in the absence of any significant event, the OCR is likely to be locked in at current levels for the foreseeable future.

The Reserve Banks's decision to reinforce the message that future interest rate rises are on hold is strongly supported by the New Zealand Institute of Economic Research's (NZIER) Shadow Monetary Policy Board (which has the task of recommending interest rate settings ahead of each decision by the Governor of the Reserve Bank). Over two-thirds of Shadow Board responses were for the OCR to stay at 3.5% (with the Shadow Board's average recommended rate remaining at 3.46 percent) with relatively few voting for a lowering (or increase) in the OCR. A wait and see approach predominates thinking at this stage, unsurprising given the balanced nature of inflation (and deflationary) pressures at present.

The New Zealand dollar – a dollar each way

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

Forecasts: Exchange Rates

	AUD (cents)		
	Mar 15	Mar 16	Mar17
Highest	0.97	0.99	0.99
Average	0.96	0.97	0.94
Lowest	0.96	0.95	0.87

	USD (cents)		
	Mar 15	Mar 16	Mar17
Highest	0.74	0.76	0.76
Average	0.73	0.71	0.71
Lowest	0.73	0.69	0.66

	TWI		
	Mar 15	Mar 16	Mar17
Highest	78.7	81.0	78.0
Average	78.0	77.1	73.8
Lowest	77.1	74.0	69.2

Source: ANZ, ASB, BNZ, and Westpac

The Australian economy is still in a relatively low growth phase with uncertainty at the political level also influencing confidence. Further reductions in Australian interest rates have seen the $NZ appreciate against the Aussie of late.

Forecasting exchange rates has not been helped by a significant move away from traditional monetary policy settings towards expansionary mechanisms such as quantitative easing and the like. With international interest rates at close to zero (with negative interest rates in some jurisdictions) and a real threat of deflation on the global scene, uncertainty is likely to prevail for some time.

Monetary policy in the United States remains lax with prospects of interest rate rises to arrest the slide in the US dollar continuing to be pushed out - evidenced by the latest statement from the Federal Reserve. We may be a long long way off monetary policies returning to their pre-GFC regimes.

Inflation – dead and buried

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

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Mar 15	Mar 16	Mar17
Highest	0.4	2.2	2.4
Average	0.3	1.5	2.0
Lowest	0.1	0.9	1.7

Source: ANZ, ASB, BNZ, and Westpac

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

1.3 Business and consumer confidence – edging up

Business confidence – consolidating

Over recent months a number of surveys have shown signs of business confidence consolidating at higher levels.

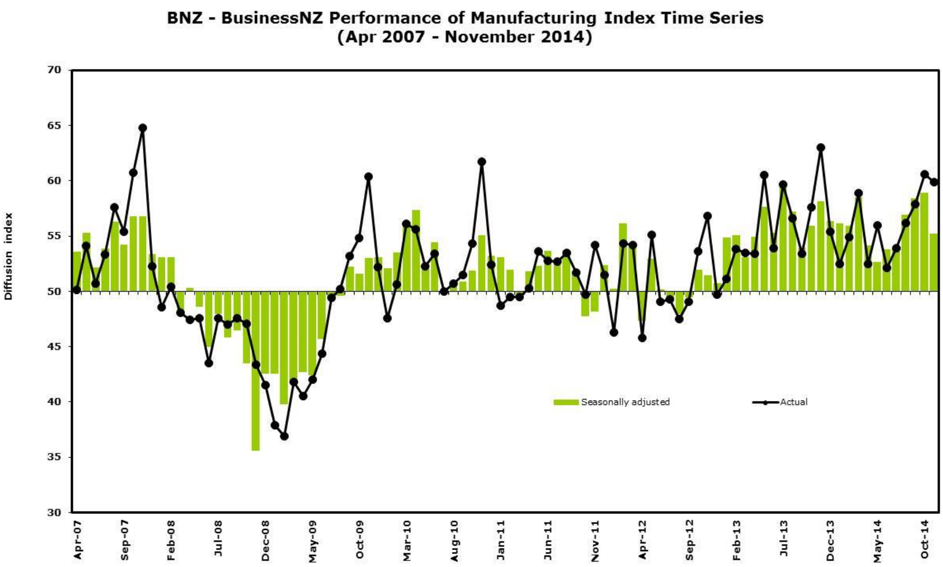
In summary, business survey data generally show businesses as very optimistic about their own business prospects, the most important indicator of future GDP growth.

Profit expectations and investment intentions remain firm, interest rates expectations have plunged and hiring intentions have somewhat improved.

All these factors point to solid growth over the forecast period.

The BNZ-BusinessNZ Performance of Manufacturing (PMI) and Performance of Services (PSI) indices continue to show relatively strong growth in both major sectors of the NZ economy. Perhaps even more importantly, both surveys point to relatively strong employment growth.

The PMI for February, seasonally-adjusted, stood at 55.9, 5.2 points higher than the previous month, and a return to levels of expansion seen before the January blip. The sector has now been in expansion for 29 consecutive months. A reading above 50 points indicates activity is expanding: below 50 indicates activity contracting.

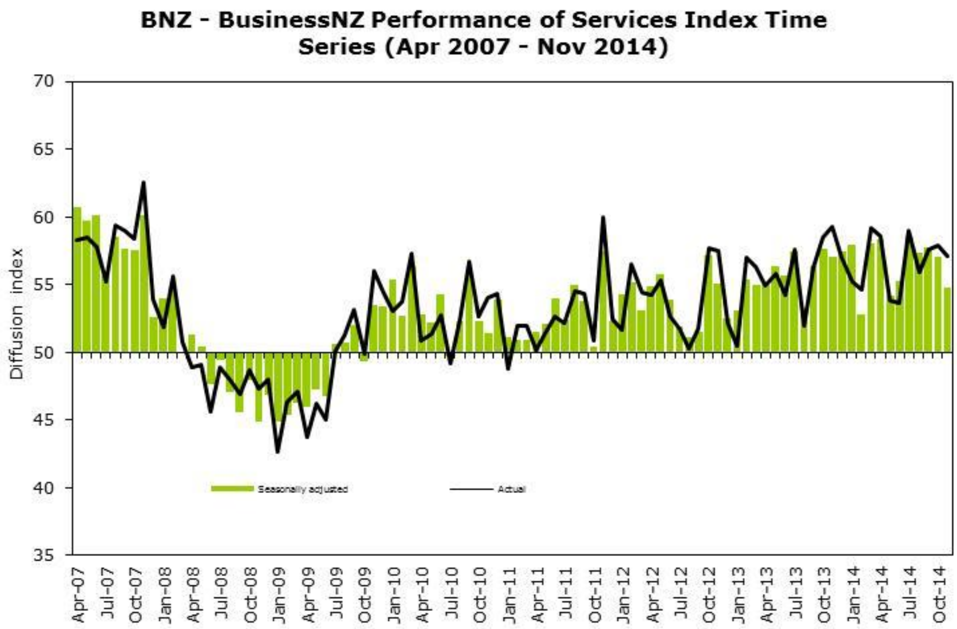


All five seasonally adjusted main diffusion indices were in expansion during February. *New orders* (61.5) led the way with its highest result since November 2013, while *deliveries* (58.2) experienced its highest value since September 2014. *Finished stocks* (52.5) and *production* (51.8) improved from the previous month.

All four regions went back into expansion during February, with similar results across most parts of the country. In the North Island, the *Northern* region (54.9) experienced similar levels of expansion to the *Central* region (55.4). In the South Island, the *Canterbury/Westland* region (55.8) improved 7.5 points from January, while the *Otago-Southland* region (60.7) recovered from a significant dip in the previous month.

Although there was a lift in expansion levels during February, the proportion of positive comments for the month (57%) was lower than in January (58.9%), December (64.3%) and November (61.4%). Globally, the JP Global Manufacturing PMI stood at 52.0 for February, a marginal lift from January.

Meanwhile the seasonally-adjusted BNZ – BusinessNZ Performance of Services Index (PSI) for February decreased 2.2 points to stand at 55.6, although still showing healthy expansion.



All five main sub-indices were again in expansion, with *activity/sales* (62.1) leading the way for the first time since November. *New orders/business* (58.1) dipped 2.9 points during February, while *supplier deliveries* (51.4) dropped 3.6 points. Both *stocks/inventories* (52.8) and *employment* (52.7) were at similar levels of expansion, with the latter back to levels of expansion seen towards the end of last year.

Activity remained positive and healthy throughout the country. In the North Island, the *Northern* region (55.4) was up 2.9 points from January, while the Central region (59.0) experienced very similar levels of expansion compared with the previous month. In the South Island, the *Canterbury/Westland* region (59.1) recorded its highest level of expansion since April 2014, while the *Otago/Southland* region (60.9) remained above the 60 point mark.

Service sector results by sub-sector were all in expansion during February, although there was a spread in the level of expansion. *Wholesale trade* (55.4) picked up from the previous month and *accommodation, cafes & restaurants* (57.1) did likewise. *Property & business services* (52.6) experienced more moderate expansion, while *health & community services* (53.1) went back into positive territory.

Despite the slight dip in expansion levels during February, the proportion of positive comments from respondents for the current month (65.5%) continued to lift, following 61.0% in January and 60.8% in December. Internationally, the JPMorgan Global Services PSI for February (54.0) accelerated to a five-month high.

Consumer confidence – solid on the back of effective "tax cuts"

Consumer confidence remains solid on the back of clear signs of interest rate rises remaining on hold for an extended period of time, relatively strong labour market growth and higher participation rates, and very subdued inflationary pressures including a relative decline in the cost of petrol.

The drop in petrol prices has effectively delivered households a tax cut and more should be in the offing when the Government reviews its Accident Compensation Corporation (ACC) levies later this year.

BusinessNZ has for a number of years expressed concern about the setting of ACC levies, namely the inconsistent approach across accounts, lack of transparency and ACC's retention of funds well in excess of an amount that can be justified under a fully-funded model.

Both employers (in respect to the ACC Work Account) and employees (in respect to the Earners' Account) are due a considerable drop in premiums for both work and non-work injuries given the current bloated state of both ACC accounts.

It is not at all obvious why ACC should build in additional risk margins beyond those required to prudently manage risk. ACC is a state-sanctioned monopoly provider of accident insurance with the power to tax employers if premiums collected in any one year are insufficient to fund the on-going costs of that year's accident claims.

1.4 Labour market – participation at record levels

Employment – growth continues

Employment growth is still relatively strong with associated reductions in unemployment as outlined below. The unemployment rate is expected to reach 5.3 percent by March 2017 although there are significant differences in rates between the higets and lowest forecast.

Forecasts: Unemployment % (HLFS)

	Quarter		
	Mar 15	Mar 16	Mar17
Highest	5.5	5.8	6.4
Average	5.5	5.3	5.3
Lowest	5.3	4.7	4.4

Source: ANZ, ASB, BNZ, and Westpac

The Household Labour Force Survey official measure of unemployment tends to mask underlying labour market developments. For example, while employment growth was relatively strong over the December 2014 quarter, the unemployment rate actually went up, the reason being record labour force participation rates.

The fact participation rates are at record levels shows that individuals and households have a degree of confidence in entering the labour market. In the past, the unemployment rate may have gone down but simply as a result of reduced participation rates as people voluntarily exited the labour market, discouraged about their prospects of gaining meaningful employment. It is therefore important when analysing labour market outcomes, to look a little beyond the headline figures. These can often distort the labour market's true underlying strength (or weakness).

Labour supply has been broadly keeping pace with employment growth largely on the back of a high level of migration and an increasing participation rate as individuals contemplate improved labour market outcomes.

The BNZ - BusinessNZ PMI and PSI surveys show solid growth in employment outcomes, both in the manufacturing and the services sectors. Other business confidence surveys also indicate strong employment growth prospects, particularly in the construction sector. The BNZ-BusinessNZ PMI *Employment* sub-index sat at 52.3 for the month of February 2015. Meanwhile the PSI *Employment* sub-index sat at 52.7.

Other forward-looking surveys such as job advertising rates continue to show modest growth, although there has been some monthly fluctuation. Nevertheless, the overall trend is up.

Labour costs – steady

Forecasts below indicate that labour costs are expected to increase only slowly to a 2.3 percent for the year ending March 2017.

Private sector salary and wage rates (including overtime) increased 1.8 percent in the year to the December 2014 quarter. Public sector salary and wage rates (including overtime) increased 1.2 percent in the year to the December 2014 quarter.

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

	Years ending		
	Mar 15	Mar 16	Mar17
Highest	2.1	2.5	2.6
Average	1.9	2.2	2.3
Lowest	1.7	1.8	2.0

Source: ANZ, ASB, BNZ, and Westpac