BUSINESS NZ
PLANNING FORECAST

SEPTEMBER 2015

Business NZ

The economy – balancing act.

Executive summary

Both qualitative and quantitative data currently show different sectors of the New Zealand economy experiencing decidedly different fortunes. While some sectors, such as construction and tourism, continue to go from strength to strength, others, particularly agriculture, have been downbeat although confidence may rise in light of the recent upturn in dairy prices, howbeit from a very low base. Still others - the manufacturing and services sectors – are still trucking on in positive territory.

Growth prospects have taken a hit but are still likely to remain at acceptable levels (around 2 percent per annum over the forecast period) compared with many countries we compare ourselves to. But risks, domestic and international, remain elevated.

At the international level, New Zealand's heavy dependence on China and Australia for well over a third of its exports will continue to affect the country's growth rate with the fall-out from dairy particularly prominent. Of some significance is an uncertainty about the quality of the growth data coming out of key economies and whether there is a reasonable understanding of how big the stockpile of dairy products is world-wide. And continuing uncertainty about China's investment slowdown (prices of key infrastructure investment inputs are markedly down e.g. 25 percent drop in cement prices since the start of 2015), along with instability on the Russian front and continuing threats of terrorism make for an interesting mix. On the other hand, economic data from the world's largest economy, the US, has generally improved and a wide range of data supports a likely interest rate rise later this year or early next.

World equity markets remain volatile with, over recent times, a drop in major markets followed by a rebound of sorts. Nevertheless, such volatility needs to be put into perspective as massive gains over the last 12-18 months were clearly unsustainable. In some markets a correction was largely overdue but although the New Zealand share market shed some value, movement overall has been negligible.

The significant slide in the NZ dollar will provide some comfort for exporters struggling with low commodity prices but the fact that commodity prices, particularly oil, have stayed low has offset any problems normally associated with a sliding currency – namely tradeables' inflation. To date this has been a non-issue but as conditions improve, upward pressure on interest rates in the United States could put further downward pressure on the NZ dollar.

Continuing low interest rates and the possibility (not guaranteed) of further cuts in the near term are likely to mean interest rates stay at levels not seen since the 1960s.

The building sector is showing renewed vitality with solid growth in building consents and pent-up Auckland demand continuing to drive prices to new highs. While the potential for financial instability should house prices suddenly collapse is causing the Reserve Bank some headaches, given continuing migration pressures this seems unlikely.

Inward migration continues to reach new highs and employment growth is still solid although tempered by increasing numbers of people entering the labour market as reflected in very high participation rates. As a consequence, it is difficult to see the unemployment rate dropping any further over the short-medium term. In fact a slight rise looks likely over the near term as outlined in the forecasts below.

On the political front, the need to stay the course and focus on matters that really count for New Zealand's future growth prospects - such as clearly defined property rights for resource use and the removal of unnecessary barriers to growth - is proving a challenge for the Government given its wafer-thin majority. Same old, same old is simply not an option if the country wants to move the needle on growth prospects and achieve the living standards most New Zealanders aspire to.

HIGHLIGHTS

The BusinessNZ Economic Conditions Index (ECI) sits at 1 for the September 2015 quarter, up 6 on the previous quarter and down 1 on a year ago.

Business and consumer confidence have continued to ease although sector confidence remains mixed.

Construction and tourism continue to perform strongly, while confidence in the agricultural sector has plummeted, despite tentative indications that international dairy prices may have bottomed out - evidenced by recent rises in the GlobalDairyTrade (GDT) auctions and the recent increase in Fonterra's forecast payout.

The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey the BNZ-BusinessNZ Performance of Services Index (PSI) show continued solid growth.

The continued slide in the NZ dollar will be a fillip to exporters while usual concerns about significant declines in the NZ dollar on tradeables' inflation has been very subdued in light of strictly limited pressures on international commodity prices, particularly oil.

While there are widespread expectations that the Reserve Bank will cut interest rates further over coming months, this cannot be guaranteed. International events (e.g. if the US tightens monetary policy sooner rather than later) could put further pressure on the $NZ.

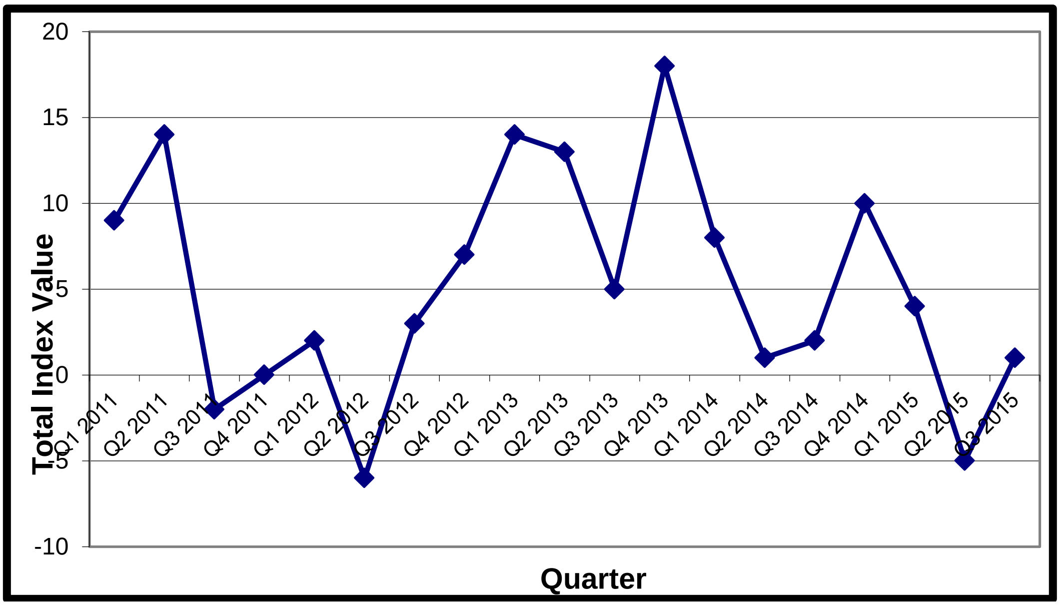
Employment growth prospects are still relatively solid but unemployment is likely to increase slightly given the high levels of inward migration and labour force participation rates remaining close to all-time highs.

PART 1: THE NZ 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 1 for the September 2015 quarter, an improvement of 6 on the previous quarter and down 1 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

Of the ECI sub-groups:

<u>Economic growth/performance indicators</u> sit at 3 for the September 2015 quarter, the same as the last quarter and the same as a year ago. The slide in international commodity prices, particularly (until recently) dairy, has impacted on New Zealand's terms of trade. However, a significant drop in the $NZ will boost returns when converted into $NZ.

<u>Monetary policy/pricing indicators</u> sit at 3 for the September 2015 quarter, up 4 on the last quarter and up 7 on a year ago. Limited inflationary pressures (both tradeables and non-tradeables), despite a significantly lower dollar, increase the potential for even further interest rate cuts although this is not a given.

<u>Business/consumer confidence indicators</u> sit at -3 for the September 2015 quarter, the same as the previous quarter and the same as a year ago. Despite negative confidence overall, quantitative data show that some sectors, including construction, manufacturing and services, are still putting in a solid performance.

<u>Labour market indicators</u> sit at 1 for the September 2015 quarter, up 2 on the previous quarter and down 1 on a year ago. Despite relatively healthy employment growth, increasing numbers entering the labour market are inhibiting the ability to put any further dent in the unemployment rate.

[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 NZ ECONOMY – WHERE ARE WE HEADING?

1.1 Economic growth (GDP) – lower growth forecast

Economic growth of around 2 percent is forecast out to September 2016, increasing slightly to 2.5 percent in 2017 (see below). While this is a significant decline from the 3+ percent projected earlier this year, it is still relatively solid compared with the growth rate of many of the countries we normally compare ourselves to.

Forecasts: Real GDP % Growth

	Years Ending		
	Sept 15	Sept 16	Sept 17
Highest	2.6	2.0	3.0
Average	2.6	1.9	2.5
Lowest	2.6	1.6	1.9

Source: ANZ, ASB, BNZ, and Westpac

The fact that New Zealand equities hardly faltered over recent times while the rest of the world faced significant volatility is reflective of still relatively strong fundamentals in the NZ economy.

New Zealand has not been affected like some countries where energy and mining have taken the biggest hits, but there are also other positive factors at play in the NZ economy.

New Zealand has significant room to move on the monetary policy front (in the form of further interest rate cuts) if things start turning nasty. Internationally, interest rates are close to zero (in fact negative in some cases as outlined below) so many central banks have strictly limited room to move. New Zealand's mortgage interest rates are now already at their lowest since the early 1960s.

World Interest Rates Table – Major Central Banks

Central Bank	Current Interest Rate
Reserve Bank of New Zealand	**2.75%**
Reserve Bank of Australia	**2.0%**
Bank of Canada	**0.50%**
Bank of England	**0.50%**
Federal Reserve	**0.25%**
Bank of Japan	**0.10%**
European Central Bank	**0.050%**
Swiss National Bank	**-0.75%**

While New Zealand's large dairy sector is a crucial component of its success and has been facing some headwinds of late, there is positive news coming out of the last three GlobalDairyTrade (GDT) auctions, along with an uplift in Fonterra forecast payout to $4.60 per kg (up from $3.85 at the start of the season). Despite this significant improvement from a low base, around $5 plus per kg is seen as required for farmers to break even given high agricultural debt levels, particularly those dairy-related.

There are also significant risks at play as New Zealand is a minuscule producer of milk in the context of global production yet a very significant player in world trade in dairy. Minor changes in production, stockpiles of milk (largely unquantifiable), or the effects of changing weather patterns (e.g. drought) can have huge implications for a small open economy like New Zealand.

Aside from dairy, many sectors of the economy are continuing to perform at relatively high levels, despite reported declines in business confidence.

Tourism and construction continue to grow at healthy rates, despite suggestions that the peak for construction activity in Canterbury has passed. The more likely scenario, according to informed Canterbury business leaders, is that the construction phase has plateaued but will remain at an elevated level for a number of years.

The manufacturing and services sectors continue to perform well with the reduction in the $NZ a fillip in terms of those exporting into international markets where the US dollar dominates. The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the BNZ-BusinessNZ Performance of Services Index (PSI), are still showing solid growth.

New Zealand Government debt levels are relatively low by international standards and provide some headroom for front-loading infrastructural investment should this be deemed appropriate. Loosening fiscal policy can certainly come with risk, particularly if investments come in the ‘nice to do’ category rather than helping make the economy more competitive.

While certainly the New Zealand economy is not immune from international volatility, the absence of pump-priming initiatives prevalent overseas means that it is largely founded on market-based fundamentals – although some questions are being raised about the drivers of the Auckland housing market.

Despite the positives, risks remain

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

- The process of moving towards more sustainable monetary policy regimes in key international markets (particularly the US and Europe)
- Ongoing uncertainty on the Russian front
- Middle East extremist factions
- The real extent of China’s slowdown, given China is New Zealand’s major trading partner.
- The outlook for Australia in light of the flow-on effects for New Zealand of a reduced demand for Australian minerals, particularly from China

Domestically, risks include:

- High levels of household and particularly agricultural (dairy) debt would increase vulnerability should dairy prices remain at low levels.
- The potential impact of drought conditions on agricultural production and capital stock numbers - as some weather experts predict an increased likelihood of prolonged drought conditions in some areas over the 2015/16 summer.
- The potential for financial instability should (although unlikely) the Auckland housing market collapses.
- The risk of record inward migration drying up.
- Potential political threats to the Government’s ability to proceed with key regulatory reforms such as reform of the Resource Management Act, and more generally in improving overall regulatory quality.

  There is a danger of the Government going into its shell and promoting only politically safe issues rather than continuing to improve the regulatory framework so businesses can feel confident, for example, about the rules that relate to future foreign investment. The intended sale (ultimately a non-sale) of Lochinver Station is a case in point. Commentators have suggested that the lack of a sale to overseas interest could knock around $20 million off the potential domestic sale price, calling into question whether the Government should be required to compensate the owners for what in effect has been a regulatory taking.

1.2 Monetary conditions – further loosening possible

Interest rates – drifting lower

The 90-day bill rate is forecast to decline slightly for the year to September 2016 and then regain some ground out to September 2017 (see forecasts below).

Forecasts: Interest Rates (90 day bills)

	Years ending		
	Sept 15	Sept 16	Sept 17
Highest	2.9	2.7	3.7
Average	2.8	2.5	2.9
Lowest	2.8	2.1	2.1

Source: ANZ, ASB, BNZ, and Westpac

The Reserve Bank reduced the Official Cash Rate to 2.75 percent (down from 3 percent) in its latest review but significantly, it left the door open for further cutting if economic conditions warrant it. The rate reduction in the latest review was widely expected by markets and endorsed by the NZ Institute of Economic Research's Shadow Monetary Policy Board. There was 63 percent support for lowering the OCR and 34 percent for the OCR remaining at 3 percent.

Despite expectations of further cuts in the OCR (with many predicting it will go to 2 percent over the next few months), this is by no means certain.

The economy is clearly on a lower growth path of around 2 percent per annum and inflationary pressures are likely to be restrained over the near term with commodity prices in particular (notably dairy) driving down demand in rural New Zealand.

Despite solid employment growth, wage pressures remain under firm control, with the expectation of a slight rise in the unemployment rate, given high entry levels.

On the other hand, a significant drop in the NZ dollar could provide some increase in tradeables' sector inflation if, as it appears, key commodity prices (again notably dairy), have bottomed out.

And continuing strong net migration and strong domestic housing demand (particularly in Auckland) are keeping house prices at historically high levels.

Given that interest rate movements are targeted at economic conditions 1-2 years down the track, the Reserve Bank might be reluctant to move rates lower if, by the middle of next year, an increase in inflationary pressure should make a rapid rate increase necessary.

It is also likely that the Reserve Bank will want to retain some ammunition should the international outlook turn really nasty. This is particularly the case when one looks at the choices a number of economies made when they joined the race to lower rates to zero (even negative) as outlined earlier. Some options then become unpalatable and problematic, for example, quantitative easing (essentially printing money), the long-term effects of which are yet to play out internationally.

The NZ dollar – slow drift south?

Forecasts show the NZ dollar is generally expected to drift slightly lower against the Australian and US dollars, although predicting its future direction is difficult, depending on which assumptions are built into models, as the significant differences in the year to September 2017 indicate (see over page).

Monetary policy in the US remains lax with the latest 2-day meeting of the Federal Reserve continuing to decline to move on interest rates. However, there is a reasonable degree of confidence that some upward movement will occur before the end of this year or early next. The prospect of interest rate rises in the US may put further downward pressure on the NZ dollar.

On the other hand, improving dairy prices and a continued strong housing market in Auckland might act to push the NZ dollar into a holding pattern. At the end of the day, about the only thing certain about the NZ dollar is that it is likely to show continued volatility as economic data provides mixed messages about the overall direction of the New Zealand economy.

Forecasts: Exchange Rates

AUD (cents)			
	Sept 15	Sept 16	Sept 17
Highest	0.91	0.92	0.92
Average	0.91	0.90	0.89
Lowest	0.90	0.87	0.87

USD (cents)			
	Sept 15	Sept 16	Sept 17
Highest	0.63	0.62	0.65
Average	0.63	0.61	0.63
Lowest	0.62	0.59	0.59

TWI			
	Sept 15	Sept 16	Sept 17
Highest	68.6	68.2	70.5
Average	68.3	66.4	66.6
Lowest	67.8	64.6	63.7

Source: ANZ, ASB, BNZ, and Westpac

Inflation – remains subdued

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

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Sept 15	Sept 16	Sept 17
Highest	0.5	2.6	2.5
Average	0.4	2.0	2.0
Lowest	0.3	1.6	1.6

Source: ANZ, ASB, BNZ, and Westpac

Notwithstanding the above, there are a number of at least potential inflationary pressures which include:

- Continued strong net inward migration adding to demand pressures.
- Elevated housing demand, particularly in Auckland, as building activity tries to catch up with pent-up demand.
- Significant decline in the NZ$ which could add to tradeables' inflation.
- Repricing of insurance risk and earthquake-prone buildings' strengthening costs.

On the other hand, some factors are acting to take to the heat out of inflationary pressures:

- Relatively flat international commodity prices, despite some increases in oil and dairy of late.
- Record low interest rates reducing debt servicing costs to both businesses and households.
- Strong and continuing competition in many sectors (particularly retail) keeping a lid on general prices.
- High population growth and relatively high labour force participation rates keeping wage pressures under firm control while making it difficult to make headway on the unemployment front.

1.3 Business activity and consumer confidence – down overall

Business activity – dropping but needs to be put in perspective

Key indicators of business activity and confidence are at lower levels.

While a number of business opinion surveys show that business confidence has taken a dive over recent months, many need to be taken with a grain of salt. There is a danger of 'reef fish mentality' when looking at the national economy compared with what conditions are like at the individual firm level.

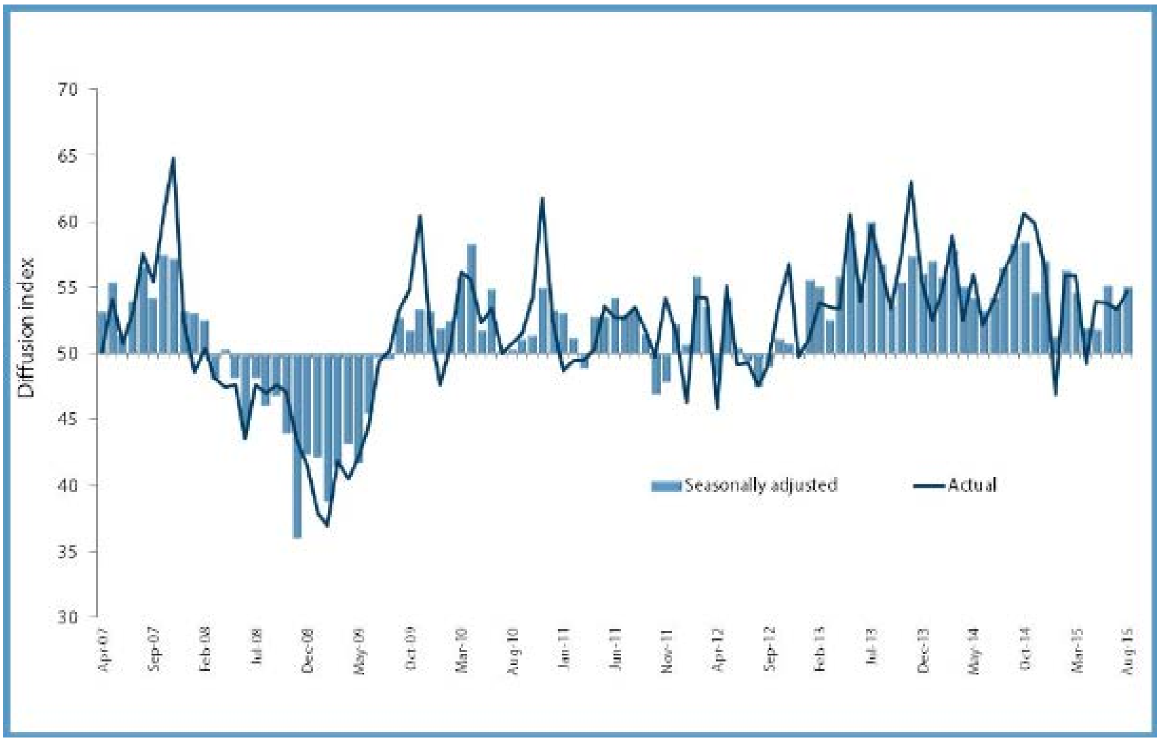
At the firm level, confidence and activity are still generally on a sound footing compared with what individuals perceive as the outlook for the economy as a whole.

Notwithstanding the above, sentiment in different sectors and regions varies widely, from a reasonable performance in the construction industry, steady progress for both the manufacturing and services sectors (see below) to downright pessimism in the agricultural sector (although there appears to be some light at the end of the tunnel given the results of very recent agricultural confidence surveys taken after the lift in GDT prices).

Perhaps an indication of the decoupling of business confidence and what is happening on the ground is well reflected in the BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the BNZ-BusinessNZ Performance of Services Index (PSI) both of which show continued solid growth.

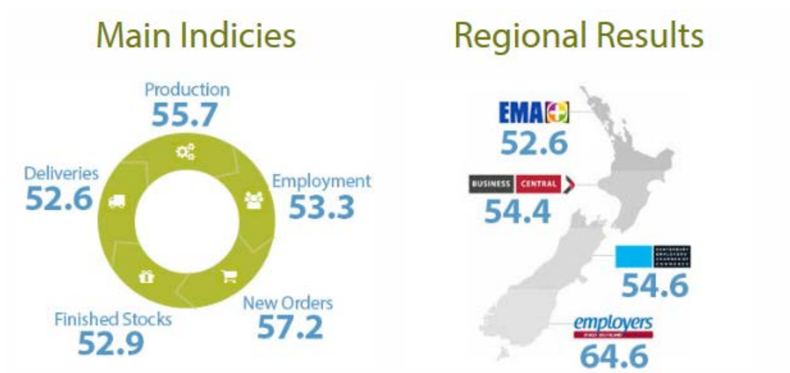
The seasonally adjusted PMI for August 2015 was 55.0 (a reading above 50.0 indicates that manufacturing is generally expanding: below 50.0 that it is declining). This was 1.3 points higher than July, and close to the level of activity experienced in June. Despite another dip in expansion, the sector has still been in the expansion zone for 34 consecutive months.

BNZ-BusinessNZ Performance of Manufacturing Index (PMI)
(2007 onwards)



The PMI's proportion of positive comments slipped from 60.8 percent in July to 57.2 percent in August. The dominant theme among positive comments was that the lower NZ dollar was helping to grow exports.

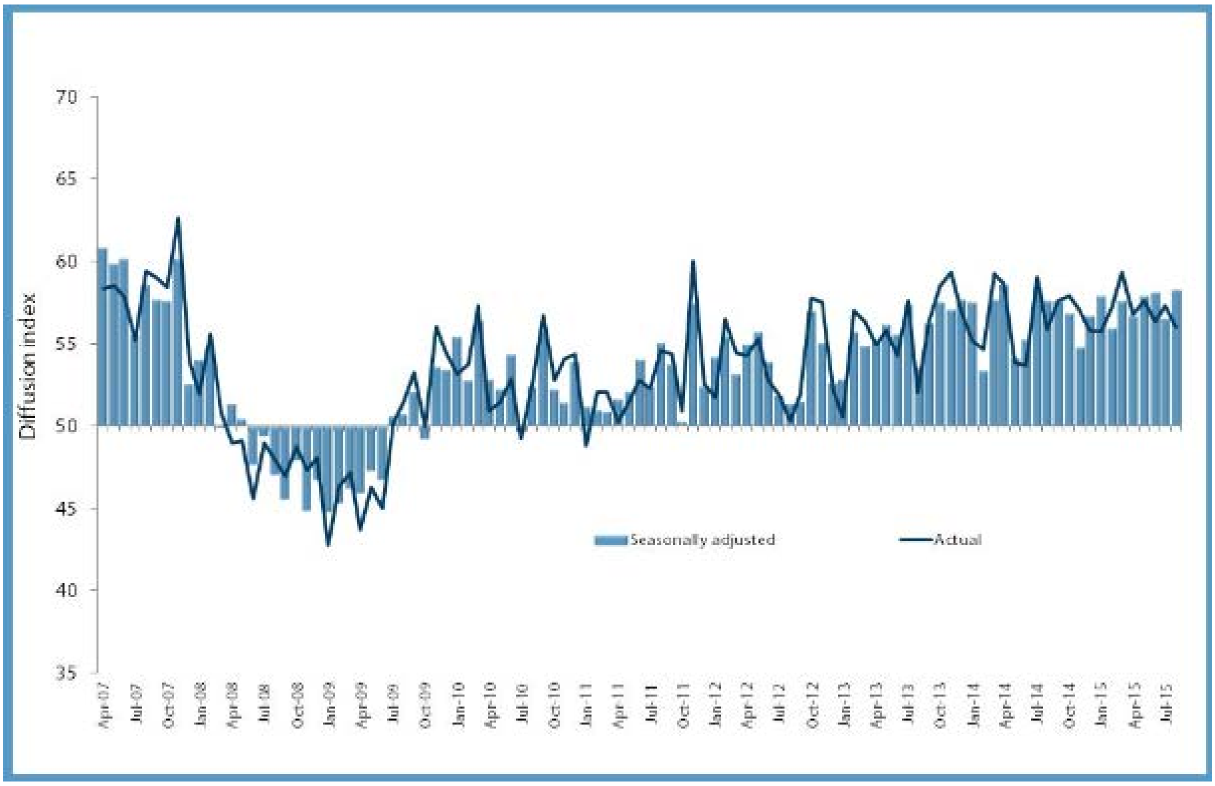
On the flipside, manufacturers noted that the new adverse economic conditions offshore are causing a drop in new orders for some, while some domestic comments noted that the dairy downturn continues to be felt.



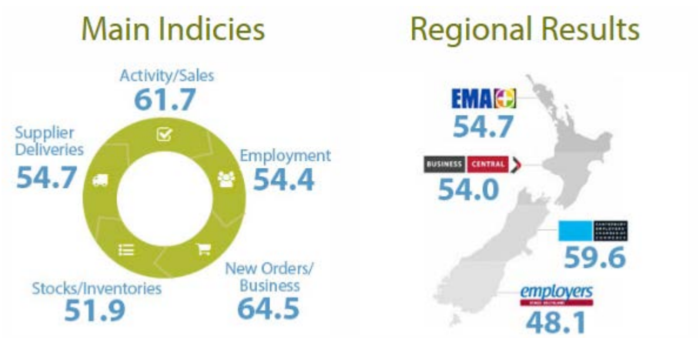
The PMI's sister survey, the BNZ–BusinessNZ Performance of Services Index (PSI), continues strongly, with further expansion in August 2015 as the PSI reached 58.2.

This was a 1.6 point increase from July and the highest overall value since July 2014 (A PSI reading above 50 indicates that the service sector is generally expanding; below 50.0 that it is declining).

BNZ-BusinessNZ Performance of Services Index (PSI)
(2007 onwards)



Key indicators of activity/sales and new orders consistently above the 60-point mark bode well for continuing growth in the months ahead.



Although the proportion of positive comments in August (59.2 percent) was lower than July (64.1 percent), those indicating positive influences noted a combination of ‘business as usual’ and new clients and opportunities.

Consumer confidence – still a little jittery

Consumer confidence, like business confidence, took a big hit mid-year but some recent surveys suggest that effect might have bottomed out.

The ANZ-Roy Morgan NZ Consumer Confidence Survey for September 2015 shows that confidence steadied after taking a significant hit over the preceding months. The index rose 1 point to 110.8 from a three-year low in August. The current conditions index fell to 114.9 from 117.2 but the future conditions component increased to 108.1 from 104.9.

The factors that assist in driving confidence higher and those which hold confidence down are finely balanced.

On the positive side, cuts in interest rates (and likely further cuts) will assist with household debt servicing costs.

Inflationary expectations are very low and despite a significant drop in the NZ dollar, tradeables' sector inflation has not been an issue – yet.

House prices have remained in positive territory (generally), providing a feel-good factor for many households.

The prospect of further cuts in Accident Compensation levies will also perhaps help raise confidence as significant cuts to the Earners' Account (and Work Account) are justified with ACC consulting on rates to apply in 2015/16 very soon. Significant cuts in Motor Vehicle Account levies from 1 July 2015 are now starting to filter through.

On the negative side, first, high debt levels remain the Achilles heel for many households, particularly if interest rates trend upwards towards more neutral levels next year.

Second, while employment growth is still relatively strong this is being largely offset with increasing numbers of people entering the labour market, bringing the labour force participation rate to a new high. This means that the unemployment rate is likely to rise, not fall, over the short to medium term.

Third, regional variations in confidence are likely to persist, particularly after the hit taken from earlier declines in dairy prices. As mentioned earlier, this will impact on growth and employment prospects as infrastructural investment in the dairy sector is reassessed in light of lower projected payouts than that achieved over the preceding years.

1.4 Labour market – flattening out

Employment – growth continues but offset by growing population

Forward-looking indicators show labour market conditions have plateaued.

Recent releases from the ANZ New Zealand Job Ads report and the Seek Employment Report show that job ads have plateaued.

Regional areas with an agricultural focus but more predominantly dairy, are showing a downturn in job ads, e.g. Waikato and Manawatu.

On the other hand, Auckland is still leading in terms of job ad numbers with a 4.6 percent lift in new jobs ads, and an annual gain of 9.2 percent. The growth has been widespread across sectors with an emphasis on legal, advertising and media, along with a continued growth in jobs involving property-related activity.

While employment growth is still relatively solid, this has been more than offset by increasing numbers of people entering the labour market with the participation rate remaining at historically high levels.

Unadjusted figures show a record net gain of 60,300 migrants in the August 2015 year with all regions having a net gain of international migrants, led by Auckland (27,900), Canterbury (6,700) and Waikato (2,300). Many of these migrants were on student visas but around 36,000 arrived on work visas. Obviously such numbers will significantly boost the size of the labour market.

As a result, the unemployment rate is likely to remain flat at best and possibly increase over the near term as outlined in the forecast below. The unemployment rate is expected to reach 6.4 percent by March 2017.

Forecasts: Unemployment percentage (HLFS)

	Quarter		
	Sept 15	Sept 16	Sept 17
Highest	6.2	6.9	6.8
Average	6.0	6.5	6.4
Lowest	5.9	6.2	5.6

Source: ANZ, ASB, BNZ, and Westpac

Labour costs – steady as she goes

Forecasts below indicate that labour costs are expected to increase only slowly to 1.9 percent for the year ending September 2017.

The latest Westpac McDermott Miller Employment Confidence Index for the September quarter 2015 shows that the number of respondents who expect a pay increase over the coming year has dropped to its lowest level since the survey began in 2004.

Private sector salary and wage rates (including overtime) increased 1.8 percent in the year to June 2015 quarter. Public sector salary and wage rates (including overtime) increased 1.2 percent in the year to the June 2015 quarter.

Despite reasonably solid employment growth, wage pressures are likely to be constrained overall, given the high numbers of people entering the labour market, including the ongoing impact of strong net inward migration.

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

	Years ending		
	Sept 15	Sept 16	Sept 17
Highest	1.8	2.5	2.5
Average	1.7	1.9	1.9
Lowest	1.6	1.5	1.4

Source: ANZ, ASB, BNZ, and Westpac