

## **Update on the Economy**

### **Introduction**

The major economic indicators show that the economy is currently in a holding pattern, although there are a number of risks both on the up side and also downside.

Business confidence has stabilised, albeit at lower levels than the past 2-3 years, while consumer confidence has weakened somewhat on the back of higher petrol prices and some nervousness about future business/employment growth.

On the up side, recent trade figures give cause for optimism with strong export growth over the last couple of months. Nevertheless, this should be taken with a grain of salt given that the middle of the year is traditionally the "high season" for agricultural exports and not too much should be read into the latest up-turn.

On the downside, a number of potential risks are evident, mainly on the international scene. The on-again off-again conflict in the middle-east, moves by Iran to proceed with development of nuclear weapons, concerns within the EU over butter quotas from NZ, the effective collapse of world trade talks (the Doha Round), and uncertainties over world oil supplies and costs, could all impact on New Zealand's domestic market. The uncertainty associated with avian influenza is also a potentially significant risk.

On the domestic scene, moves by Government to increasingly tinker with markets, a greater degree of intervention and a lack of a clear reform agenda, will likely cause businesses to take a wait and see approach to major new investments.

### **Economic Outlook**

Despite the negative sentiments expressed in a number of business opinion surveys, when the major indicators are looked at in more detail, the economic outlook is reasonably positive.

The economy has recovered from the short lull in the second half of 2005 and projections are for increased growth for the remainder of this year and into the next.

The Business NZ Performance of Manufacturing Index (Business NZ PMI) shows that activity is positive (53.9 in July, up 1.9 points from June) and the key factors in the index show expansion e.g. new orders and production. However, on the downside, employment prospects are down slightly, albeit close to the 'no change' threshold.

As has been stated before, it is perhaps strange that business perception of business conditions is quite low, conflicting with firms' own activity expectations – a key indicator of likely economic growth going forward.

Growth expectations remain positive but consistent with slower economic growth (around 1.5% for 2006 and 07) before a reasonable strong recovery in 2008 (to around 3%).

On the positive side of the ledger, there is stronger confidence within the export community buoyed along by a lower dollar, although there are arguments that the dollar will need to decline further for significant gains to arise. Moreover, while the weaker currency is providing a platform for a strong pick-up in export performance, the lag between a reduced currency and improved export performance can be up to 2 years. On the other hand, concern about inflationary pressures is more prevalent with these projected to continue over the short to medium term while profit margins are being squeezed.

The ANZ Commodity Price Index in world price terms has stabilised of late but is slightly down on a year ago (-2.1%). In New Zealand dollar terms the index rose 0.6% in July, to hit a four-year high for the series and is now 9.1% higher than a year ago reflecting the depreciation in the NZ dollar compared to our major trading partners over the first quarter of 2006. A further weakening in the NZ dollar will provide a buffer for the possibility of slower world growth and hence any reduced demand for our exports.

The merchandise trade account recorded a deficit in June of \$214 million, which was far better than the deficit of twice this figure the markets had predicted. The difference mainly reflects unusually strong dairy exports. Over the June quarter export receipts were up 16.2% while import payments were up by 10.1% with exports boosted by some late upswing in the dairy sector. The annual trade deficit now sits at \$6.6 billion compared with \$6.9 billion in May and \$5.2 billion a year earlier. Given the recent decline in the currency and expectations of further depreciation, it would seem fair to predict that the annual trade deficit is likely to have peaked and will slowly improve over the next year or so.

The June quarter CPI result of 1.5% (4% annual) was higher than market expectations with housing, oil and petrol prices continuing to be the main culprits.

The big question is whether firms will respond to reduced profit margins by trying to pass on cost increases thereby raising inflation or by reducing output by cost-cutting and reduced employment. The particular path followed could well determine the pace of inflation adjustment.

The net result of the above is that the Government's coffers will start to feel the pinch next year and with continued strong projected growth in government expenditure, the government's operating surplus (while still significant at around \$7 billion (4.5% of GDP)) will start to come under pressure.

## **Interest and Exchange Rates**

The Reserve Bank (RB) has retained the OCR at 7.25% despite inflationary pressures still being an issue.

The RB has quite rightly decided to look through current inflationary pressures (which are largely beyond New Zealand's control), and focus on the longer-term outlook. However, the Reserve Bank has clearly indicated that there will be no cuts in floating interest rates for a significant period while noting yet again that inflationary pressures are stronger than previously anticipated.

While inflationary pressures have been driven largely by fuel/transport costs and the housing sector, with these pressures predicted to remain well into next year, the longer term outlook is for a gradual reduction in inflationary pressures with inflation well within the Reserve Bank's 'target' of 1-3% by 2008.

The housing market is continuing to slow with indications that home ownership is declining further as first homebuyers 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.

Either of these assumptions could be misleading, particularly if the net inflow of migrants does not increase substantially (it has increased slowly over the last quarter but still annual gains are a modest 10-12,000 per annum) and/or there is a slow down in employment growth or possibly negative employment growth, as some forecasters have predicted for next year.

Over the year to June 2006 house prices were up by just over 12% while rents were up just 2.6%. Over the last 5 years the contrast has been just as stark. While house prices have close to doubled over the last 5 years (up 93%) rents have risen just 13.5%. In real (inflation-adjusted) terms, rents have fallen slightly over the last five years.

Interest rate rises are starting to bite as households' fixed term rates come up for renewal. Compared to a few months ago, the ability to lock into longer-term low rates has reduced and this, along with rising fuel costs, is starting to hit consumers in the pocket. New car sales continue to flatten and are slightly down on a year ago. Current changes in consumer behaviour illustrate the "lag" effect of last year's Reserve Bank interest rate increases.

The \$NZ is still holding up pretty well after the sudden drop in the first quarter of this year. Since April 2006 the dollar, on a Trade-Weighted Index (TWI) basis, has remained around the 62-63 cent mark, although on a day-to-day basis it has fluctuated quite substantially around this level. Nevertheless, the long-term trend is still downwards.

The interest rate gap (return) from investing in New Zealand compared to our major trading partners continues to close with upwards inflationary pressures in both Australia and the United States encouraging their respective monetary authorities to increase interest rates in response (with Australia recently lifting the OCR to 6% - the highest since early 2000 as a result of growing inflationary pressures). Investors will increasingly look to these economies for investment opportunities rather than to NZ. A further significant further drop in the NZ dollar is quite likely over the next 1-2 years; however given current inflationary pressures the Reserve Bank would probably like the dollar to stabilise for some time around current levels.

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