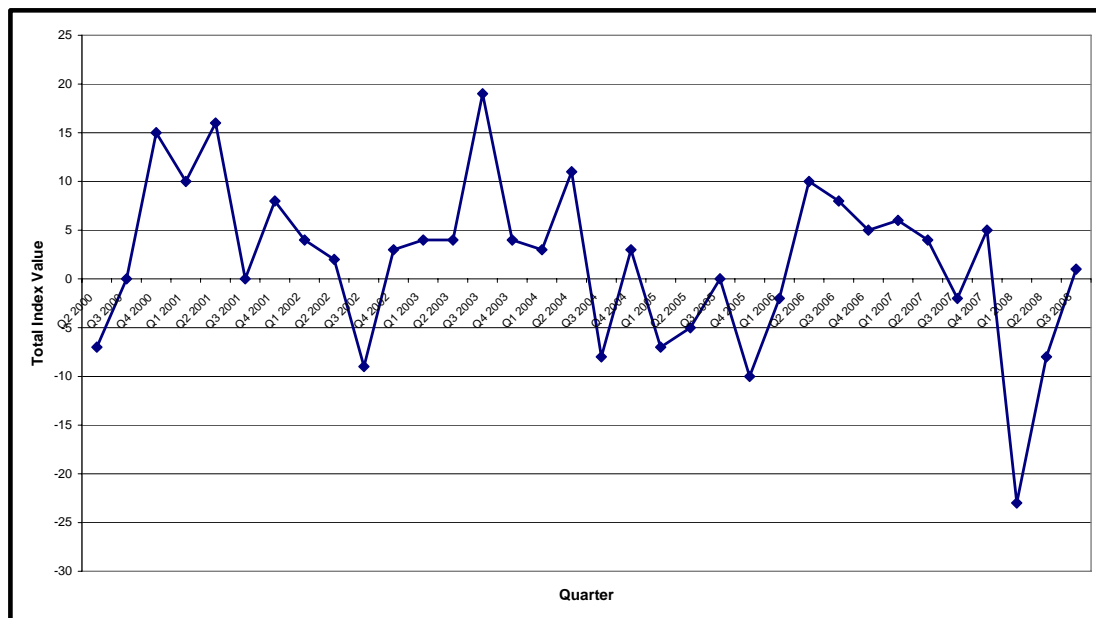


October 2008

## EXECUTIVE SUMMARY

The overall Business NZ Economic Conditions Index sits at 1, up 9 on the June quarter and a significant 24 on the March quarter 2008. While the overall index now sits on the positive side of the ledger (just), the outlook has deteriorated rapidly with the international credit crunch resulting in a repricing of credit risk and a generally lowering world growth outlook. Despite measures by Governments and central banks around the world to shore up financial markets, markets remain extremely volatile. World commodity prices have plunged but on the positive side it has taken the heat out of international inflationary pressures with international oil prices having dropped by over 50 percent in the last three months.

**Figure 1: Overall economic conditions index**



<sup>1</sup> A Background to the Economic Conditions Index, including measuring movements in the indicators and a glossary of terms, is contained in the Appendix. It is important that the caveats to the Index as outlined in the Appendix are clearly understood.

## In terms of the sub-indexes:

1. **Economic growth/performance indicators** sit at 2, up 6 on the last quarter and up 2 on a year ago. Official figures confirmed NZ had a technical recession for the first half of 2008 (2 negative quarters of GDP growth), while expectations are that the September quarter will also be negative. The current account balance took a whack in the June quarter after showing an improvement in preceding quarters on the back of strong international commodity prices. Reduced export volumes and a surge in imports (some “one-offs” such as an oil rig and floating platform) tended to skew the June quarter result. Nevertheless, international commodity prices in general are trending down after reaching historical peaks over the last year, which will impact on NZ’s terms of trade. Moreover, hope that reductions in international oil prices will flow through into reduced costs for businesses and households must be tempered with caution given the continued trend downwards in the NZ dollar.

2. **Monetary policy/pricing indicators** sit at 4, up 3 on the previous quarter and up 3 on a year ago. The continued improvement in this sub-index has been driven by a lowering in both interest rates and exchange rates which are now both starting to slide. Banks are competing strongly for market share as householders’ fixed mortgages come up for renewal and there is an expectation of further significant cuts in the OCR. Nevertheless, significant drops in the OCR will not necessarily result in similar cuts to interest rates facing households and businesses given NZ’s reliance on overseas borrowing and a repricing of risk and credit on international markets. Inflationary pressures have eased somewhat with oil prices having stabilised for the time being at around \$US70 per barrel. However, any continuing slide in the NZ dollar will feed through into imported inflationary pressures. Producer input prices remain high, putting real pressure on some sectors.

3. **Business/consumer confidence indicators** sit at -1, up 4 on the last quarter and at the same level as the same time last year. Both business and consumer confidence have returned as interest and exchange rates continue to drop, while pressure on household budgets should decline on the back of lower debt servicing costs. However, it should be noted that most surveys of business and consumer confidence do not take into account the recent financial turmoil over the past 2-3 weeks. For the first time in 7 years, household debt levels have declined slightly although households will continue to suffer falls in equity as the housing market looks to re-price at more sustainable levels. Banks will likely require increased equity from households to reduce their exposure to a declining housing market, placing some households under considerable financial strain. The household sector is battering down the hatches as reflected in reduced retail sales and other indicators of household demand activity, such as electronic card transactions and building activity.

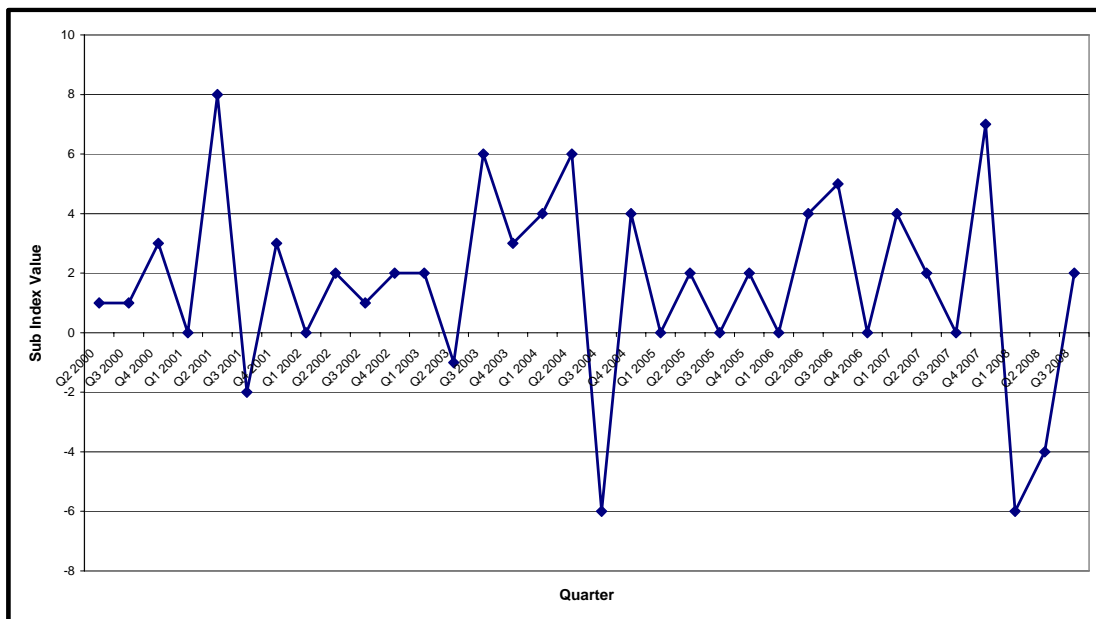
4. **Labour market indicators** sit at -4, down 4 on the previous quarter and down 2 on a year ago. After strong and consistent growth in labour market indicators for a number of years, expectations are for further rises in unemployment and reduced employment opportunities. Trends in official data have been difficult to predict of late in respect to labour market activity with indicators tending to bounce around wildly over the last few quarters. Nevertheless, on balance, indicators are for reduced labour market pressures over coming quarters although wage pressures continue to be evident despite a slow-down in demand.

## BUSINESS NZ ECONOMIC CONDITIONS INDEX

### Sub Index 1: Economic growth/performance indicators

Economic growth/performance indicators sit at 2, up 6 on the last quarter and up 2 on a year ago. Official figures confirmed NZ had a technical recession for the first half of 2008 (2 negative quarters of GDP growth), while expectations are that the September quarter will also be negative. The current account balance took a whack in the June quarter after showing an improvement in preceding quarters on the back of strong international commodity prices. Reduced export volumes and a surge in imports (some “one-offs” such as an oil rig and floating platform) tended to skew the June quarter result. Nevertheless, international commodity prices in general are trending down after reaching historical peaks over the last year, which will impact on NZ’s terms of trade. Moreover, hope that reductions in international oil prices will flow through into reduced costs for businesses and households must be tempered with caution given the continued trend downwards in the NZ dollar.

Figure 2: Economic growth/performance sub index



Officially NZ was technically in recession (defined as two consecutive quarters of negative GDP growth) for the first half of 2008 as confirmed with the recent release of GDP figures for the June quarter 2008 which showed the economy slipping backwards by 0.2 percent for the quarter. GDP was down 0.3 percent the previous quarter. Annual growth was still a relatively healthy 2.6 percent for the June 2008 year, although it is likely that growth for the September quarter will also be negative.

The flow-on effects of the drought early this year are continuing to impact on agricultural production with activity in primary industries down 0.6 percent in the June 2008 quarter.

Total export volumes decreased 0.2 percent for the June quarter, mainly due to a 17.7 percent decrease in exports of dairy products. On the other hand, total import volumes were up 3.3 percent, but some of this increase was due to the import of

“one-off” items relating to the oil industry, reflecting a strong investment in plant machinery and equipment (up 15.6 percent) for the quarter.

Service industries recorded their first quarter of negative growth since 2002, down 0.4 percent for the June 2008 quarter. The largest contributors to this decline were finance, insurance and business services (down 0.7 percent), retail, accommodation and restaurants (down 1.9 percent) and wholesale trade (down 1.2 percent).

Activity in goods-producing industries was down 0.2 percent in the June 2008 quarter, with construction activity (down 3.8 percent) the main contributor to the decline. Perhaps surprisingly, offsetting this negative outcome was improvement in manufacturing activity (up 1.4 percent in the June 2008 quarter). However, the increase in manufacturing activity was largely due to a 2.6 percent increase in food, beverage and tobacco manufacturing.

The NZIER Consensus Forecasts, released on 23 September 2008, show that market forecasters expect GDP growth to be negative for the September quarter 2008 although on an annual basis GDP growth is expected to be marginally positive (0.2 percent) in 2008/09 before recovering to 3.1 percent by 2010/11. A 0.2 percent rate would be the lowest annual growth rate since 1992/93.

Forecasters also expect a further weakening in private consumption and a sharp contraction in residential investment.

The current account deficit took a hit in the June quarter 2008. The gradual improvement experienced since the March quarter 2006 (when the current account deficit peaked at -9.3 percent of GDP) has been reversed somewhat with the annualised current account deficit for the year ending June 2008 approaching \$15 billion (8.3 percent of GDP).

The principal components driving the wider than expected deficit were stronger imports and weaker earnings reported by offshore subsidiaries. A larger goods and services deficit, mainly driven by increased goods and services imports, made the largest contribution to the wider deficit. The investment income deficit was driven by higher profits achieved by foreign firms operating in NZ compared to a fall in income earned by NZ investments offshore.

Given that NZ terms of trade (price of exports versus price of imports) have peaked, and the ongoing cost of servicing a large stock of debt, it is looking likely that the current account deficit will remain at present levels for some time. Indeed, the NZIER Consensus Forecasts (September 2008) show deterioration in the outlook for the current account compared to previous forecasts in June 2008.

**Table 1: Current account balance**

	Annual total (\$ millions)	% of GDP
Mar 2005	-10,267	-6.8
Jun 2005	-11,389	-7.5
Sep 2005	-12,242	-8.0
Dec 2005	-13,262	-8.3
Mar 2006	-14,668	-9.3
Jun 2006	-14,203	-9.3
Sep 2006	-14,272	-8.9

Dec 2006	-13,785	-8.8
Mar 2007	-14,096	-8.3
Jun 2007	-14,096	-8.4
Sep 2007	-14,892	-8.7
Dec 2007	-14,372	-8.2
Mar 2008	-14,211	-8.0
Jun 2008	-14,968	-8.3

In terms of world growth, forecasts have been cut sharply as the fall-out associated with the credit crunch continues to move from the US into Europe and to a lesser extent Asia.

There has been a continuing raft of negative financial news stories coming out of the US for the best part of a year, starting with the collapse of the sub-prime housing market, the Federal Government bail-out of Freddie Mac and Fannie Mae, the collapse of Lehman Brothers (the world's fourth largest investment bank), the fire sale of Merrill Lynch to the Bank of America, and the bailout of AIG by the State.

These events have heightened the panic over what former Federal Reserve Governor Alan Greenspan has called a "once-in-a-century" financial crisis.

The major (estimated at \$US700 billion) Government bailout of bad debts still clogging up the financial system was initially defeated (narrowly by a vote of 228-to-205) by Congress. This had immediate implications for Wall Street with US stocks taking a hammering. However, after some significant tweaking of the package (including support measures to appease a number of vested interest groups), the bailout has been passed by both Congress and the Senate as widely expected although the costs has blown out by an estimated \$100 billion in the process.

There has been a conceptual debate as to whether the Government should have bailed-out the corporate sector to prevent further losses, given that some commentators have rightly stated that much of the current and previous crisis can be put down to lax banks ready and willing to lend to anyone who comes through the door irrespective of credit risk. The difficulty with the rescue package is that market risks have been effectively transferred from the private sector to taxpayers (i.e. effectively nationalising marginal sub-prime loans) and this has not been going down too well with the American public – who ultimately will pay the price for such (state socialism) largesse.

While it is possible to have some sympathy for this approach, the danger is that the damage on the way through could have been horrific. On the other hand, coming to the aid of large corporates has seen a market surge in confidence on the back of effective government guarantees. This may not be particularly helpful in ensuring assets are re-priced at realistic levels. Knowing that the government will likely step in to bail out corporates will encourage them to be less risk averse, and heighten the likelihood of the same thing happening again.

Despite efforts by many Governments and central banks around the world trying to shore up financial markets with capital injections and government guarantees, markets remain highly volatile.

What does all this mean for NZ and are we vulnerable to the global financial crisis?

In the first instance, global growth forecasts will be reduced as risk and uncertainty increase the cost of credit (already happening), while investors will simply be more

risk averse to new investments. This means that banks will be much more wary of who they lend to, irrespective of interest rate hikes.

The reliance of Kiwi banks, companies and households on offshore finance (about one-quarter of bank finance comes from offshore) will place increased pressure on interest rates. On the other hand, reduced global growth should continue to take the pressure off oil prices which are currently hovering around \$US70 per barrel; down substantially from \$147 reached a couple of months ago.

NZ's net international liabilities now exceed \$150 billion and act as a significant drag on the country's ability to reduce the current account deficit over the short to medium term. Debt makes up the vast bulk of NZ's international liabilities (around 88 per cent of the total), and increases in interest rates since early 2007 have made servicing that debt more expensive.

The extent of NZ's external imbalance leaves the country vulnerable given that international investors are re-pricing risk and credit is becoming internationally more expensive in light of recent events. In this respect, its large external deficit leaves NZ susceptible to a change in investor sentiment as the country relies heavily on external funding for its investment needs. With banks obtaining about a fifth of their money from offshore, it is a moot point whether there is any chance of a significant decline in household interest rates.

Despite the above, NZ is in a very useful position in terms of our fiscal and monetary policy settings should the impact of the global financial crisis be more prolonged and deep-seated.

In terms of monetary policy, the Reserve Bank has, until recently, maintained a relatively tight stance in light of inflationary pressures. With the Official Cash Rate (OCR) currently sitting at 7.5 per cent, there is plenty of room for dropping it further.

NZ banks are also not involved in many of the complex financial transactions that have caused significant losses for many large global institutions. But despite the lack of direct involvement, NZ banks will be indirectly affected by financial prices as added uncertainty will ensure that investors become increasingly risk averse.

In respect to NZ's fiscal position, operating balances have declined but are still in positive territory, while NZ has operated cash surpluses until recently. Therefore there is still room for further fiscal stimulus if this was considered absolutely necessary. NZ government debt is also low by international standards, providing a cushion against a potential downturn. While the pre-election Economic and Fiscal Update (6 October 2008) shows a significant deterioration in NZ's fiscal position, by international standards, New Zealand is still in a reasonable position to weather any significant global downturn.

Growth in NZ is expected to pick up in 2009 as a result of a number of positives likely to impact on output at that time. These include the combined effects of personal income tax cuts which have just started recovery in agricultural production from the drought of 2007/08, added expansion in the dairy sector as a result of significant conversions, and finally, expectations of further, perhaps significant, cuts by the Reserve Bank in the OCR.

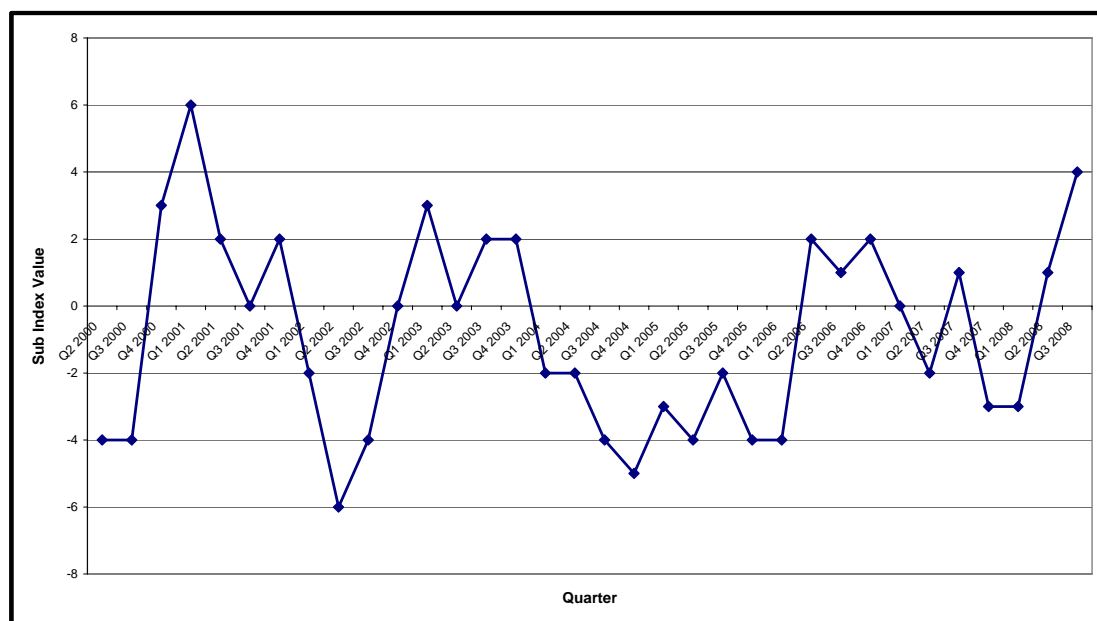
**Table 2: Real Gross Domestic Product  
(annual average % change)**

	NZ	Australia	USA	Japan	UK
Mar 2005	3.8	2.8	3.4	2.0	2.7
Jun 2005	3.2	2.8	3.1	1.7	2.3
Sep 2005	2.9	2.8	3.1	1.5	1.9
Dec 2005	2.7	3.3	3.1	1.9	1.7
Mar 2006	2.7	3.4	3.1	2.4	2.2
Jun 2006	2.2	3.0	3.2	2.5	2.3
Sep 2006	1.7	2.9	2.9	2.5	2.7
Dec 2006	1.6	2.4	2.9	2.4	2.9
Mar 2007	1.6	2.7	2.4	2.5	3.4
Jun 2007	2.1	3.3	2.1	2.4	3.5
Sep 2007	2.7	3.8	2.2	2.3	3.3
Dec 2007	3.1	4.5	2.2	2.1	3.1
Mar 2008	3.0	4.4	2.4	1.6	2.6
June 2008	2.6	3.7	2.4	1.3	-

## Sub index 2: Monetary policy/pricing indicators

Monetary policy/pricing indicators sit at 4, up 3 on the previous quarter and up 3 on a year ago. The continued improvement in this sub-index has been driven by a lowering in both interest rates and exchange rates which are now both starting to slide. Banks are competing strongly for market share as householders' fixed mortgages come up for renewal and there is an expectation of further significant cuts in the OCR. Nevertheless, significant drops in the OCR will not necessarily result in similar cuts to interest rates facing households and businesses given NZ's reliance on overseas borrowing and a repricing of risk and credit on international markets. Inflationary pressures have eased somewhat with oil prices having stabilised for the time being at around \$US70 per barrel. However, any continuing slide in the NZ dollar will feed through into imported inflationary pressures. Producer input prices remain high, putting real pressure on some sectors.

Figure 3: Monetary policy/pricing sub index



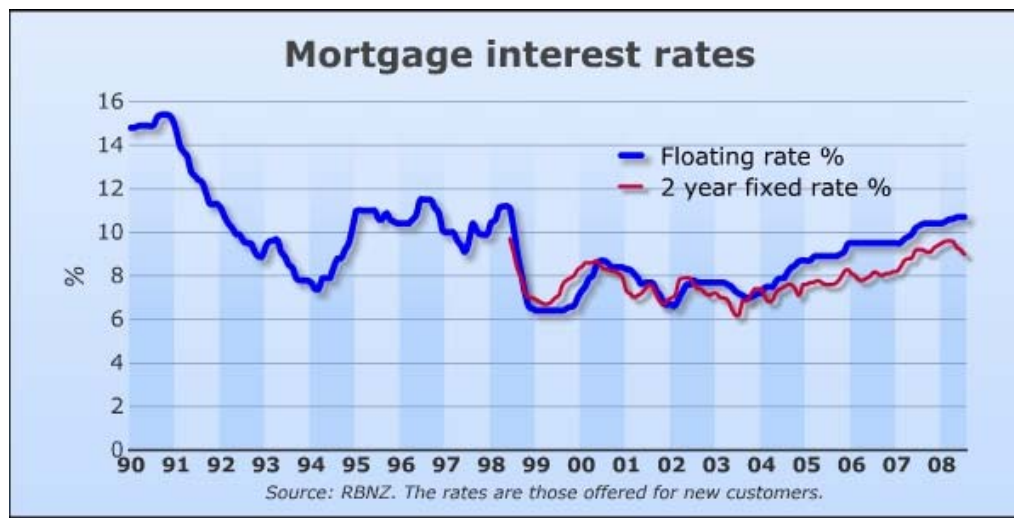
The Reserve Bank lowered the OCR from 8.0 to 7.5 percent at the last review (mid-September). Markets generally considered that a 25 basis point reduction was a certainty but a 50 basis point cut was not widely expected given ongoing inflationary pressures. Some commentators almost called the Governor of the Reserve Bank reckless and implied that he had given up on inflation altogether.

In hindsight the debate lasted all of a couple of days before further turmoil on international markets resulted in a further trimming back of global growth forecasts and international commodity prices, including oil. This reinforced what was a good decision by the Reserve Bank although at the time of the announcement the banks action did seem premature and the criticism engendered was fair to say the least.

While official data released since the time of the last cut in the OCR has been rather benign, confirmation of negative growth for the June quarter and the likelihood of a similar result for the September quarter, along with negative news in the retail and

construction sectors, not to mention the housing market, will result in significant further cuts over the next few months. However, markets have already priced in further cuts in the OCR which is one reason why these will not necessarily result in further rates cuts for businesses and households. Banks have been fighting hard for market share as fixed mortgages come up for renewal. As can be seen below, 2-year fixed rate mortgages have dropped around 1 percent of late while floating rates have remained relatively stable.

**Figure 4: Mortgage Interest Rates**



Perhaps more importantly, a significant repricing of risk in light of the international credit crunch also supports the view that there is no guarantee a drop in the OCR will see interest rates facing businesses and households reduce. Given New Zealand's exposure to debt, repricing of risk has resulted in higher interest rates internationally and means that those providing funding to banks via capital markets are likely to demand higher risk margins. This will obviously flow on to the cost of capital for businesses and ultimately householders. There is already evidence that some major business projects and mergers have been put on hold because of the difficulties in actually getting financial packages together.

**Figure 5: Exchange Rate**



Inflation is expected to peak at 5 per cent per annum in the September quarter – well outside the 1-3 per cent target band. Looking beyond the short term inflationary pressures, there is a danger that people factor inflationary expectations into their pricing decisions and wage bargaining. For example, there have been instances of businesses entering into price escalation contracts based on movements in the producers price index (PPI), which may be totally unrelated to price movements in their particular sector. Given recent movements in producer price inputs, this would be a sure recipe for a wage price spiral.

The PPI inputs index rose 5.6 percent for the June quarter 2008 with input prices for electricity generation and supply rising 50.8 percent over the quarter. On an annual basis input prices rose 11.8 percent between the June 2007 and the June 2008 quarters. Over the same period, output prices rose 8.5 percent. Given the significant rise in input costs, some of the gloss associated with high international commodity prices until recently, has been taken off producers.

Unlike a number of NZ's major trading partners, the Reserve Bank has significant room to reduce interest rates should this be seen as necessary further down the track (see below). Many other countries have already dropped their rates to low levels thus allowing little room to move further if necessary. In this respect, New Zealand is in a reasonably comfortable position to move if necessary.

**Table 3: World interest rates**

Central bank rate (%)	Current rate (%)	Previous rate (%)
Reserve Bank of Australia	6.00	7.00
US Federal Reserve	1.50	2.00
Bank of Canada	2.50	3.00
Bank of England	4.50	5.00
European Central Bank	3.75	4.25
Japan	0.50	0.25
Reserve Bank of NZ	7.50	8.00

The Finance and Expenditure Select Committee has recently released its long-awaited report on the *"Inquiry into the future monetary policy framework"*, a report which was undertaken after the Select Committee decided to look at NZ's monetary policy framework on 24 May 2007. Submissions were called for and the Select Committee heard oral submissions, which included obtaining information from independent experts. Attached as a fundamental part of Business NZ's submission was its publication *"OCR – the Sharpest tool in the Box?"*

The final report of the Select Committee is useful in the sense that while it confirms that the monetary policy framework in NZ is fundamentally sound and should not be touched, it makes some very useful points in respect to monetary policy needing assistance from both fiscal and regulatory policy. The report also mentions the fundamental need to improve productivity outcomes towards achieving long-term sustainable growth.

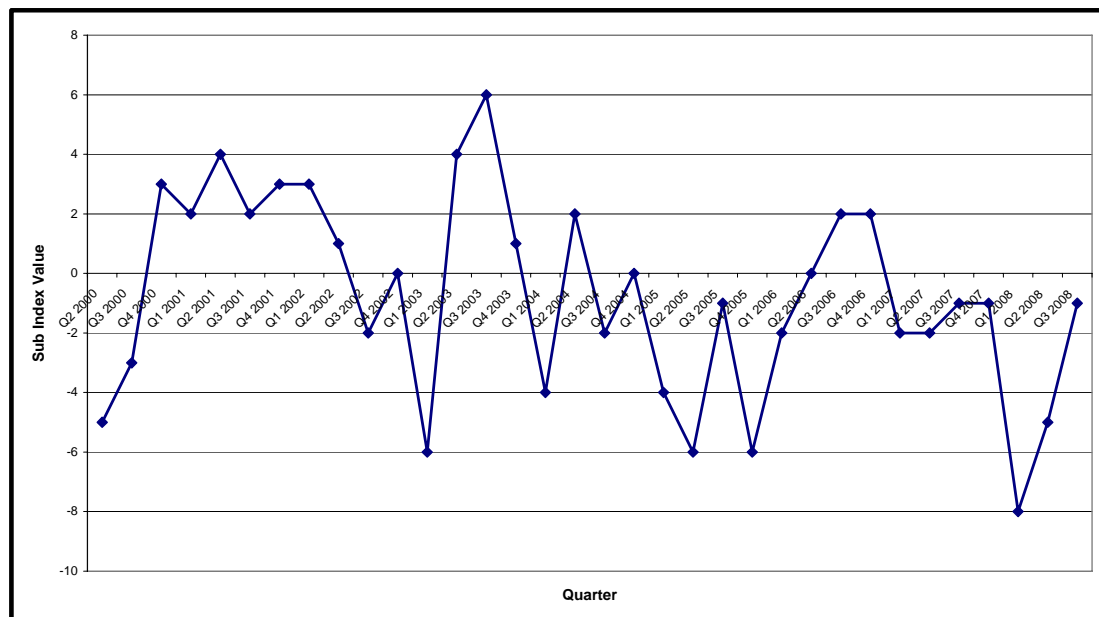
The key findings of the Select Committee and Recommendations to Government can be found on p.5-7 of the full report by clicking on the following link:

[http://www.parliament.nz/NR/rdonlyres/51084E05-C9EC-4C7F-889B-5F1F52A5A8CC/93817/DBSCH\\_SCR\\_4210\\_6281.pdf](http://www.parliament.nz/NR/rdonlyres/51084E05-C9EC-4C7F-889B-5F1F52A5A8CC/93817/DBSCH_SCR_4210_6281.pdf)

### Sub Index 3: Business/consumer confidence indicators

Business/consumer confidence indicators sit at -1, up 4 on the last quarter and at the same level as the same time last year. Both business and consumer confidence have returned as interest and exchange rates continue to drop, while pressure on household budgets should decline on the back of lower debt servicing costs. However, it should be noted that most surveys of business and consumer confidence do not take into account the recent financial turmoil over the past 2-3 weeks. For the first time in 7 years, household debt levels have declined slightly although households will continue to suffer falls in equity as the housing market looks to re-price at more sustainable levels. Banks will likely require increased equity from households to reduce their exposure to a declining housing market, placing some households under considerable financial strain. The household sector is battering down the hatches as reflected in reduced retail sales and other indicators of household demand activity, such as electronic card transactions and building activity.

Figure 6: Business/consumer confidence sub index



After initially dropping with a thud in the December quarter 2007 and staying at low levels throughout the first half of 2008, business confidence has rebounded significantly over the September quarter as evidenced by both the latest NZIER Quarterly Survey of Business Opinion (October 2008) and the National Bank's Business Outlook (September 2008). Notwithstanding the latest results, there has been some commentary along the lines that the latest results are already history given that they essentially preceded the recent financial crisis in the US which is correct to a degree. Nonetheless, while this is partially true, there has been some positive news which would support the latest rise in business confidence as not being a "one-off".

In terms of business, interest rates are moving down (notwithstanding what is happening on Wall Street) while the long-awaited decline in the exchange rate has

occurred which will take some of the pressure off exporters and boost returns. On the other hand, producer input prices remain high which is impacting on returns to businesses, along with the slide on international commodity prices, albeit from a high base.

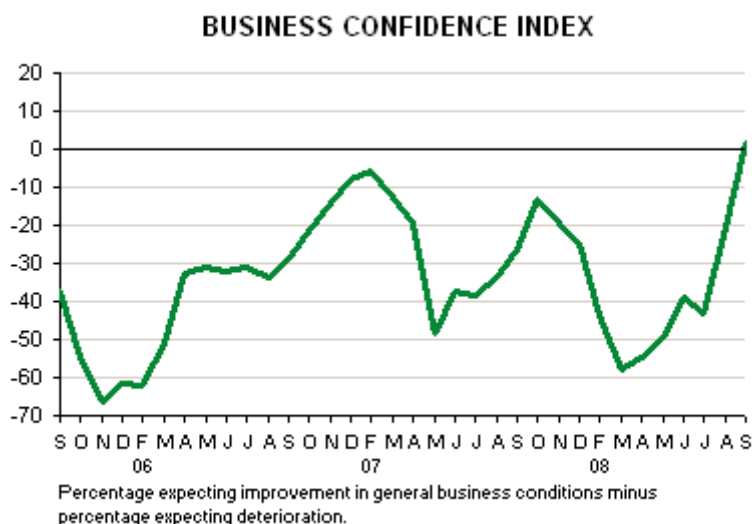
While Business Opinion Surveys on the general economic situation need to be taken with a healthy grain of salt as they can reflect individual “bias”, the more important and useful indicator of business confidence is firms’ own recorded activity and expectations going forward.

The National Bank’s Business Outlook (September 2008) shows a net 2 percent of respondents expect the general economic situation to improve over the coming year (up from a net -20 percent in August) with confidence up in all sectors, but particularly in respect to construction, retailing and services.

Much more importantly, firms’ own activity expectations have risen strongly as well, with a net 16 percent expecting improving times ahead – up 12 percentage points from the previous month. While individual business expectations are still considerably below their long-term average, the direction of confidence over the last two months is very positive. Nevertheless, given the recent financial turmoil, it is likely that business and consumer confidence will plummet when the next survey results are announced later this month.

Some might well say that such confidence is unjustified in light of recent world events. Nevertheless, NZ is in a relatively good position to weather the international financial storm, as mentioned earlier.

**Figure 7: National Bank Business Confidence Index**



Other indicators of business confidence show that things are very much in a holding pattern at present. The Bank of NZ – Business NZ Performance of Manufacturing Index (PMI) and Performance of Services Index (PSI) have both shown continued declines over recent months.

In terms of consumers, declines in interest rates and long-awaited personal income tax cuts will boost disposable income while for the first time in a long while household debt levels appear to be close to peaking – and actually dropped slightly over the

second quarter of 2008. Nevertheless, high levels of household debt are acting as a significant constraint on household spending, while equity in the housing market is being steadily eroded in light of the continued decline in house prices – with expectations of further declines well entrenched in the public’s mind.

The big issue facing households in NZ continues to be high debt levels, and the ability to service that debt. While not significant, a number of mortgagee sales have been reported of late while a number of major company mortgage investment funds have been frozen, further impacting on consumer confidence.

According to the NZ Federation of Family Budgeting Services more working families than ever before are seeking assistance through Family Budgeting Services. The 12 months to 30 June 2008 saw a surge in salary and waged clients to over 30 per cent of the total client base. A common theme appears to be the increase in mortgage repayments (debt servicing costs).

With the credit squeeze now resulting in banks repricing risk, a number of households will likely be required to increase their equity over the short-term or face having their house sold from under them. The days of banks lending 95 or even 100 percent of the cost of housing are now well and truly over. Deposits of around 20 percent will likely be required to provide some sort of a buffer to banks should the housing market suffer further significant declines.

Household debt levels are currently sitting at 161 percent of disposable income and debt servicing costs are 14.6 per cent of disposable income. Relief from interest rate rises cannot come soon enough for many households and businesses. Many of the latter have mortgaged their houses to fund small business expansion.

**Table 4: Household debt**

<b>Quarter</b>	<b>Household debt as % of disposable income</b>	<b>Debt servicing as a % of disposable income</b>
Sep 03	124	9.1
Dec 03	126	9.3
Mar 04	127	9.6
Jun 04	129	9.8
Sep 04	130	10.1
Dec 04	133	10.6
Mar 05	137	10.9
Jun 05	140	11.4
Sep 05	143	11.7
Dec 05	147	11.9
Mar 06	149	12.3
Jun 06	151	12.5
Sep 06	152	12.6
Dec 06	154	12.8
Mar 07	157	13.1
Jun 07	159	13.5
Sep 07	160	13.8
Dec 07	161	14.2
Mar 08	162	14.4
Jun 08	161	14.6

According to the REINZ Housing Market Report (September 2008), the median house price dropped from \$340,000 in June and July to \$330,000 in August. This represents a 5.71 percent drop on the August 2007 national median price of \$350,000.

While prices have continued to come off their high, the big issue facing the housing market is that of house sales and days taken to sell the average property. Sales collapsed in May (down to 4,372) and have dropped further to 4,220 in August 2008 – the lowest in 26 years since the REINZ began compiling figures. Perhaps not surprisingly in the current market, the number of days taken to sell has remained high at 55 days for August 2008, up from 33 days in August 2007. Perhaps more alarming, is that these figures relate to actual house sales, not to houses that are taken off the market and then put back on or placed with a new real estate company. This tends to downplay the real pressures on the housing market. What these figures would also suggest is that as the number of people being forced to sell or downsize increases, the price of housing will also take a hit.

**Figure 8: House prices and value of housing stock**



According to the Westpac McDermott Miller Consumer Index, consumer confidence nosedived in the June 2008 quarter but recovered strongly in the September quarter to reach a respectable 104.8. An index number over 100 indicates there are more optimists than pessimists, while a number under 100 indicates that pessimists outnumber optimists. However, it is not all good news for consumers.

**Table 5: Westpac McDermott Consumer Confidence Index**

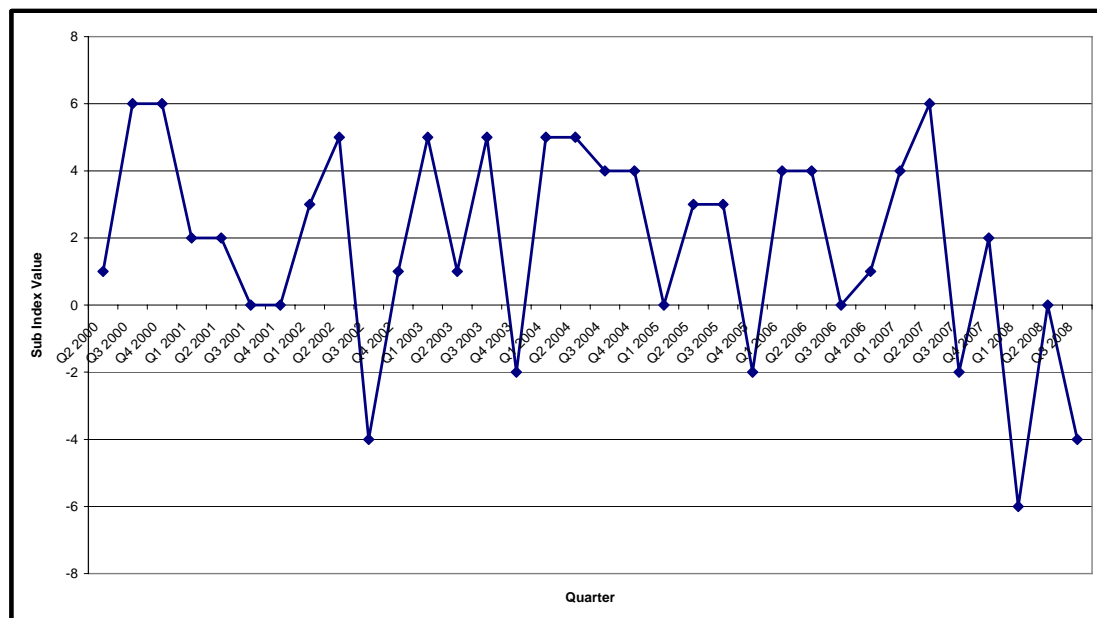
<b>Quarter</b>	<b>Index</b>
Dec 04	130.2
Mar 05	126.7
Jun 05	120.2
Sep 05	120.2
Dec 05	110.1
Mar 06	109.3
Jun 06	106.0
Sep 06	111.7
Dec 06	119.7
Mar 07	117.7
Jun 07	111.4
Sep 07	113.5
Dec 07	110.0
Mar 08	96.5
Jun 08	81.7
Sep 08	104.8

Consumers may well batten down the hatches over the near term as the housing market takes a pounding during the next few months and expectations of further employment cuts flow through. On the other hand, reductions in interest rates (mixed at this stage), increased disposable income through personal income tax reductions, reduction in petrol prices and the start of day-light savings are all likely to mean consumers have an added spring in their step. However, as mentioned above, pressures being brought to bear on consumers have resulted in cheque books being put in the bottom drawer. This is reflected in a number of indicators such as electronic card transactions, retail sales (with motor vehicle retailing continuing to take a hit as consumers pull back on discretionary spending) and a further trend downwards in building consents.

## Sub Index 4: Labour market indicators

Labour market indicators sit at -4, down 4 on the previous quarter and down 2 on a year ago. After strong and consistent growth in labour market indicators for a number of years, expectations are for further rises in unemployment and reduced employment opportunities. Trends in official data have been difficult to predict of late in respect to labour market activity with indicators tending to bounce around wildly over the last few quarters. Nevertheless, on balance, indicators are for reduced labour market pressures over coming quarters although wage pressures continue to be evident despite a slow-down in demand.

Figure 9: Labour market sub index



Recent official labour market data have been difficult to interpret given that this has yo-yoed over recent quarters. Nevertheless, very recent opinion surveys would suggest that reduced employment and rising unemployment is on the cards. There have been a number of high profile companies which have announced significant lay-offs of late.

The September quarter 2008 Westpac McDermott Miller Employment Confidence Index is sitting at 121.1, which is up marginally on the 120.8 recorded for the previous quarter. While 121.1 would appear on the surface to show reasonably strong confidence (with an index above 100 indicating there are more optimists than pessimists), it is the second lowest result recorded since the survey began four years ago. Most respondents considered that jobs are still relatively easy to come by, their own jobs are relatively “secure” and they can expect further wage rises over the coming year. However confidence has continued to slip compared with a year ago when the index sat at 135.9. However, most respondents thought that job opportunities would be scarcer in a year’s time.

**Table 6: Employment Confidence Index (ECI)**

Quarter	ECI (based on all questions)
Sept 07	135.9
Dec 07	133.5
Mar 08	128.8
Jun 08	120.8
Sept 08	121.2

The relatively positive results are not necessarily mirrored by employment intentions shown in other business opinion surveys.

The NZIER Consensus Forecasts (September 2008) show that forecasts of the unemployment rate have worsened since the previous survey in June. Forecasters on average expect the unemployment rate to be 4.4 percent in the March 2009 year, up from 4.2 percent in the previous survey.

The unemployment rate is expected to increase to 4.9 percent in 2009/10 before easing slightly to 4.8 percent in 2010/11.

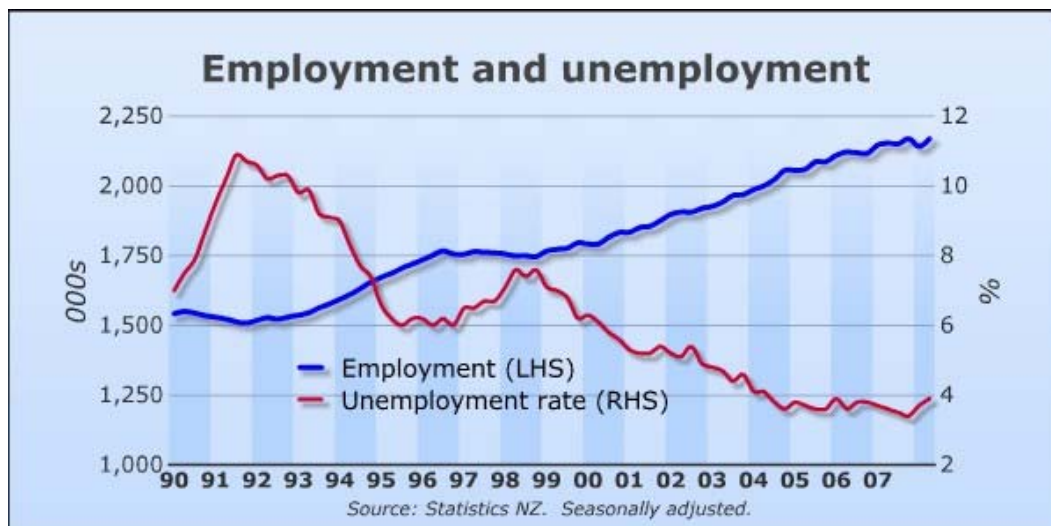
The pre-election Economic and Fiscal Update also forecast higher levels of unemployment and slow employment growth than previously.

At the coalface, businesses have been laying off staff with the Bank of NZ – Business NZ Performance of Manufacturing Index (PIM) showing that *The Employment Activity Index* (45.4) is at the lowest level recorded since the PMI series began in August 2002.

While these results may provide concrete evidence of a rather pessimistic employment outlook, they need to be seen in the light of strong employment growth since 2000 and also low levels of unemployment.

Moreover, it is possible that employers may 'hoard' skilled labour to some extent during the current downturn, simply because the transaction costs of recruiting can be significant. Employers may therefore be reluctant to release much labour at this stage.

**Figure 10: Employment/Unemployment**



Net migration (which is a good leading indicator of general economic activity going forward), has stabilised at around 5,000 per annum, but is substantially down on the 10,000 average inflows for the last 10 years.

A net inflow of 40,800 non-NZ citizens and a net outflow of 35,900 New Zealand citizens were recorded in the year ended August 2008. The majority of the net outflow of NZ citizens was to Australia (33,400) followed by minor net outflows to the United Arab Emirates (500), Canada (400) and the United Kingdom (300).

**Table 7: Net permanent migration**

<b>Year ended August</b>	<b>Net gain or loss from permanent and long-term migration (rounded to nearest 500)</b>
1998	-3,000
1999	-11,000
2000	-10,000
2001	-4,500
2002	36,000
2003	41,000
2004	19,000
2005	6,500
2006	12,500
2007	9,000
2008	5,000

The net outflow to Australia of over 33,000 people was the highest since the February 1989 year (33,600), although there were also earlier peaks in the January 1989 year (33,700) and the December 1979 year (33,400).

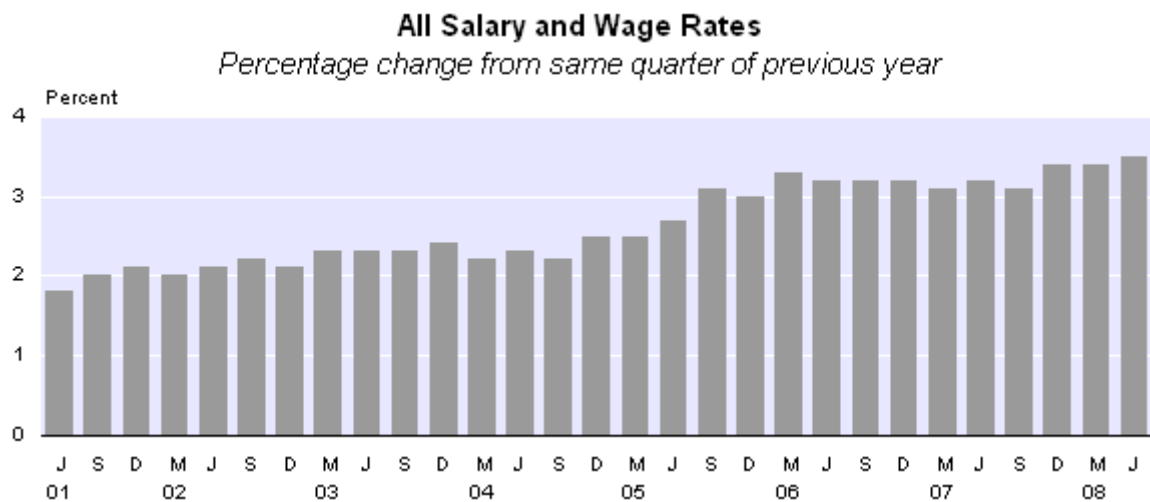
The net outflow to Australia was spread across both age and occupational groups with migrants aged 15-29 years accounting for around 40 percent of the total.

The continued low net inflow of migrants will possibly reduce the extent of rises in unemployment due to the restricted pool of labour. However, it also means less skill capacity in NZ and continued upward pressure on wages, given limited flexibility to provide more labour. Despite labour market pressures easing, expectations are for further significant rises in wages over the coming year – a continuation of their strong growth over the last three years.

The Labour Cost Index (LCI) recorded an increase of 3.5 per cent in salary and wage rates (including overtime) for the June 2008 year. This is the highest annual increase recorded since the series began in the December 1992 quarter. By comparison, the Quarterly Employment Survey (QES) recorded an average total hourly earnings increase of 5.2 percent in the year to the June 2008 quarter.

In the LCI, salary and wage rates (including overtime) increased 0.8 percent in the June 2008 quarter. This followed rises of 0.7 percent in the March 2008 quarter and 1.1 percent in the December 2007 quarter.

**Figure 11: Wages and Salaries**



While public sector wage growth rose by a moderate 0.6 percent for the June quarter, annual growth has increased by 3.7 percent, with the local government component increasing 4.5 percent over the same period. As widely accepted, this will put stronger pressures on the private sector to match rises being achieved in the public sector.

The NZIER Consensus Forecasts (September 2008) show that private sector wage growth is expected to rise even further before easing in 2010/11. Given some of the expectations surrounding wage bargaining at the moment, if successful, such wage claims may well result in a harder landing in respect to job losses than is currently the case. This will not be helped by the Government's continued drive to increase the minimum wage, acting as a driver for further wage claims based on relativity arguments.

## APPENDIX 1:

### Background to the economic conditions index

The Economic Conditions Index tracks 32 indicators on a quarterly basis. The overall index value for any particular quarter represents the net balance of the 32 indicators (generally the number increasing minus the number decreasing) thus providing an overall measure of performance.<sup>1</sup>

For the purpose of this index, if an indicator improves it is given a ranking of 1. If it stays the same it is ranked as a 0 (no change) and if it deteriorates it is given a ranking of -1. For example, if 15 indicators improve, 15 deteriorate and two stay the same, then the overall index would state no change (i.e. 0).

The index backdates data to mid-2000 to provide for a reasonable time series.

The 32 indicators contain official 'hard' data (e.g. employment/unemployment rates) and more qualitative data (e.g. business/consumer opinion surveys).

In general, increases in an indicator are seen as positive (for example, growth in Gross Domestic Product or employment) while declines in an indicator are generally seen as negative. However, this is not universally the case. For example, declines in unemployment are considered to be positive and increases in unemployment negative.

It should be noted that some indicators are difficult to categorize as good or bad, depending on the relative state of the economy (e.g. a rising/declining exchange rate relative to our trading partners). Therefore, certain indicators have not been included in the index, such as exchange rates, while others, such as net permanent and long-term migration, have been included (increases positive, declines negative).

Similar concerns can be expressed in relation to movements in the Consumers Price Index (CPI) where generally speaking, a rising CPI is considered to be negative for the economy while declines or even negative CPI growth for a quarter or so can be considered positive.

Despite this, significant and persistent declines in the general level of prices can have adverse impacts on asset prices and households' general net wealth, so prolonged deflation can be negative on the economy. For this reason a rising CPI is to be considered negative but smaller quarterly rises are seen as positive.

Declines in the CPI are seen as positive for a quarter as well as positive thereafter, providing the CPI decline is relatively smaller. In most cases this has minimal effect on the overall measure of inflation given that the occasions on which measures of the CPI (tradables/non tradables inflation) have been persistently negative, are infrequent.

As there is a significant time-lag between the end of a quarter and obtaining its official data, the last quarter measured in the index will contain only partially official figures with which to identify changes from the previous quarter. For this reason, where updated figures are not yet available at the time of release, the previous

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<sup>1</sup> Note: where monthly data only is available (e.g. Business NZ's PMI and some interest rate measures) it has been averaged over the relevant quarter for consistency.

quarter's index value will be generally carried forward (e.g. previous quarter 1, current quarter 1; previous quarter -1, current quarter -1; previous quarter 0 (no change), current quarter 0 with the latest quarter being updated as new information comes to hand.

While the Economic Conditions Index provides a useful measure of overall performance, it is desirable to group indicators into sub indexes so the main drivers of quarterly economic performance can be identified. Four sub-indexes (each with eight indicators) record movements in the following categories:

### ***Sub Index: Economic growth/performance indicators***

- (a) *Gross Domestic Product*
- (b) *Export volumes*
- (c) *Export value*
- (d) *Import volumes*
- (e) *Import value*
- (f) *Current Account balance*
- (g) *NZ's overseas debt*
  - (i) *Corporate sector*
  - (ii) *Official Government debt*

### ***Sub Index: Monetary policy/pricing indicators***

- (a) *Producers Price Index (Inputs)*
- (b) *ANZ Commodity Price Index*
  - (i) *World Price Index*
  - (ii) *NZ \$ Index*
- (c) *Official Cash Rate (OCR)*
- (d) *90-day Bank Bills*
- (e) *Variable first mortgage housing rates*
- (f) *Inflation (CPI)*
  - (i) *Tradable sector inflation*
  - (ii) *Non-tradable sector inflation*

**Sub Index: Business/Consumer Confidence Indicators**

- (a) *New Zealand Institute of Research Quarterly Survey of Business Opinion (QSBO)*
  - (i) *General business situation*
  - (ii) *Businesses own activity*
- (b) *Westpac McDermott Miller Consumer Confidence Index*
- (c) *Business NZ's Performance of Manufacturing Index (PMI)*
- (d) *Business NZ's Performance of Services Index (PSI) - NEW*
- (e) *Retail sales*
- (f) *Building permit issues dwellings*
- (g) *Household debt*
  - (i) *% of disposable income*
  - (ii) *debt servicing as % of disposable income*

**Sub Index: Labour market indicators**

- (a) *Net gain/loss from permanent and long-term migration*
- (b) *Labour force participation rate*
- (c) *Employment*
- (d) *Unemployment rate*
- (e) *Labour Cost Index – salary and wage rates*
- (f) *Level of Job Advertising*
- (g) *Job Ad rates*
- (h) *Work stoppages (person days of work lost)*

**Data Sources:** Business NZ, Statistics New Zealand, Reserve Bank of New Zealand, New Zealand Institute of Economic Research (NZIER), ANZ Bank, Westpac, Department of Labour (DOL).

## APPENDIX 2:

### Glossary of terms

#### **ANZ Commodity Price Index**

Measures the price of a number of commodities. Two indexes are included. The first provides commodity prices in world price terms. The second provides commodity prices in NZ dollar terms.

#### **Job Ad rates**

Measures the percentage of job advertisements compared to the total number of jobs. A greater number of jobs advertised compared to the total number of employed indicates a higher Job Ad rate (%).

#### **Level of Job Advertising**

Measures the level of job advertising (seasonally-adjusted) from both newspapers and the internet.

#### **Building consents issued (dwellings)**

Consents issued by local authorities for the building of residential dwellings.

#### **Business NZ's Performance of Manufacturing Index (PMI)**

A monthly index which measures five significant components of manufacturing activity.

#### **Consumer Price Index (CPI)**

Measures the change in prices of goods and services relating to households.

#### **Current Account**

The current account balance is the difference between the payments NZ receives from overseas and the payments NZ makes. It includes the balance of merchandise trade, services and investment income.

#### **Deflation**

A general decline in the price of goods and services.

#### **Disposable income**

Total after tax income.

#### **Employment (HLFS)**

The proportion of the labour force employed.

#### **Export prices**

Domestic currency export prices.

#### **Gross Domestic Product (GDP)**

The total market value of goods and services produced in NZ after deducting the cost of goods and services used in the process of production over a given time period.

#### **Household debt**

Measures the claims on households. Normally measured either as claims as a percentage of nominal disposable income or as debt servicing (interest) costs as a percentage of nominal disposable income.

**Import prices**

Domestic currency import prices.

**Labour Cost Index (*salary and wage rates*)**

The salary and wage rates component of the Labour Cost Index (LCI) measures movements in base salary and ordinary time and overtime wage rates. The LCI has fixed industry and occupational weights and measures changes in salary and wage rates for a fixed quantity and quality of labour input.

**Labour force participation rate**

The percentage of the working age population in the labour force.

**Net gain/loss from permanent and long-term migration**

Measures the net difference between overseas migrants who arrive in New Zealand intending to stay for a period of 12 months (or permanently), plus New Zealand residents returning after an absence of 12 months or more, minus New Zealand residents departing for an intended period of 12 months or more (or permanently), and including overseas visitors departing New Zealand after a stay of 12 months or more.

**NZ Institute of Economic Research's Quarterly Survey of Business Opinion (QSBO)**

A survey of business opinion reflecting the business outlook for the economy as a whole and for firms actual and intended business activity.

**NZ's Overseas Debt**

Measures corporate and official debt owed overseas. It is a gross figure which includes liabilities only and does not take account of overseas assets held by New Zealanders.

**Nominal Income**

Income without taking account of inflation or other factors which may impact on purchasing power.

**Non-tradables sector inflation**

Inflation for goods and services traded domestically (i.e. goods and services not subject to fluctuations in exchange rates).

**Official Cash Rate (OCR)**

The interest rate the Reserve Bank sets in conducting monetary policy. Commercial banks can borrow cash overnight from the Reserve Bank at an interest rate of 25 basis points above the OCR, and deposit cash at 25 basis points below the OCR.

**Producers Price Index (PPI)**

The PPI outputs index measures changes in prices received by producers. The PPI inputs index measures changes in costs of production excluding labour and depreciation costs.

**Real Income**

Income after taking account of inflation or other factors impacting on the purchasing power of money.

**Retail trade**

Retail trade statistics measure the sales from a wide range of businesses that provide household and personal goods and services. Retailers include supermarkets, bookshops, restaurants, hotel, motels, repairers of household equipment and motor vehicles.

**Seasonal adjustment**

Adjusting a time series to measure and remove the regular seasonal components (e.g. the effect of Christmas on retail sales).

**Tradables sector inflation**

Inflation for goods and services that can be traded on international markets (i.e. those goods and services subject to fluctuations in exchange rates).

**Unemployment rate (HLFS)**

The proportion of the labour force not in work, but actively seeking employment.

**Variable first mortgage housing rate**

Measures the floating cost of borrowing money secured by housing assets as opposed to the fixed rate which measures the cost of borrowing for a specified period of time and does not fluctuate during the length of time the mortgage is on a fixed rate (typically 1-5 years).

**Westpac McDermott Miller Consumer Confidence Index**

Measures consumer responses to a number of questions which reflect consumer confidence levels.

**Work Stoppages (person days of work lost)**

Number of person days of work lost as a result of a strike or lockout.

**90-day bill rate**

Defined as the interest yield on 90-day bank bills. Rates are closely related to movements in the Official Cash Rate (OCR).