



BERL Monthly Monitor

February 2011

Nation-building is the task ahead

Without doubt, 04 September 2010 was bad. And the emotional, physical, community and economic recovery was always going to be a long haul. But, 22 February 2011 makes it just, so, so much harder.

It is going to take years of effort, resources, people, communities and businesses working together to pull Christchurch and Canterbury out of the dust and ruins.

The belief that has guided me throughout my career as a professional economist is that economics is, first and foremost, about people. And people got hurt on 22 February. And that means our economy – and all the potential and opportunities that it can provide for us and our future generations – got hurt. Yes, it hurts; and it will continue to hurt. And not only will Christchurch and Canterbury hurt. New Zealand will hurt.

The region's and nation's people and community organisations are undoubtedly able and willing to meet the challenges head on. But, the damage to business, networks, confidence and people's jobs and incomes cannot be healed quickly. And, unfortunately, the financial situation of NZ – including the business sector and the government – could not be said to be fighting fit to tackle this task.

But tackle it we must.

For New Zealand will be so much the poorer without the capacity, resources, skills and potential that remains in

the Christchurch and Canterbury economy. New Zealand needs Christchurch and Canterbury. And Canterbury and Christchurch needs New Zealand.

In many ways the current situation calls for a very old-fashioned concept – that of nation-building. Where nation-building encompasses effort across many facets of life – institutions, relationships, physical structures, communities, societies, businesses, job opportunities and responsibilities.

Our forebears built this nation. Whether from Ngāi Tahu in the south to Ngāpuhi in the north, or on one of the four ships that sailed into Lyttelton, or on one of the many sailing or flying craft that have arrived on these shores, they have endowed us with this nation.

It is now in our hands to re-build, re-new and re-energise a significant part of this nation, and so to ignite the aspirations of future generations – just as our forebears did for us. This should (and will) be the primary goal of economic activity over the coming years.

In the short term this will definitely divert resources (people and dollars) away from other industry and business. This will cause some of the conventional economic performance indicators to look sad. But the longer-term goal of restoring the Christchurch, Canterbury and New Zealand's economic potential, capacity and opportunities must be paramount.

Christchurch and Canterbury: we stand with you. Kia kaha.

Global economy slowly on the mend

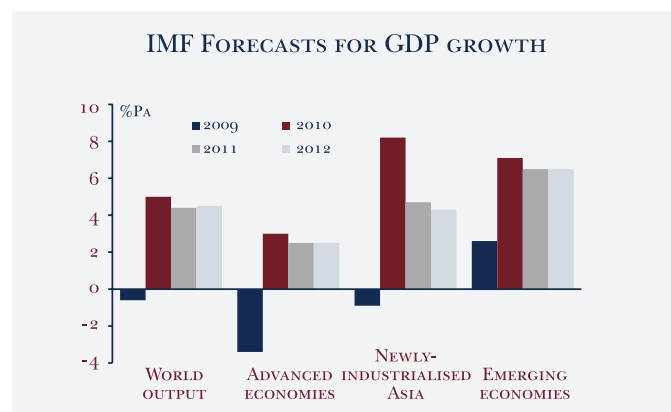
The latest World Economic Outlook from the International Monetary Fund (IMF) indicates that, in general, financial conditions are expected to remain stable or improve throughout 2011.

For the advanced economy group economic activity is projected to expand by 2.5 percent during 2011/12. This is an increase of 0.25 percent compared to the WEO released in October 2010.

The upwards revision in their projected economic activity is mostly due to the fiscal packages passed in the United States and Japan late in 2010. For the group of emerging economies, economic activity is projected to expand by 6.5 percent during 2011/12. Asia (excluding Japan) is expected to grow by 8.5 percent. But the main concern here is the emergence of growing inflation pressures due to high commodity and food prices.

The Managing Director of the IMF noted last month that while a global recovery is underway it is not the recovery that was most wanted. This recovery is one of tensions and strains and is unbalanced across and within countries.

Across countries, economic growth remains below potential in the advanced economies while in emerging and developing economies



activity is growing much faster. Within countries, unemployment is high and income inequality is adding to social strains. "Without jobs and income security, there can be no rebound in domestic demand, and ultimately, no sustainable recovery."

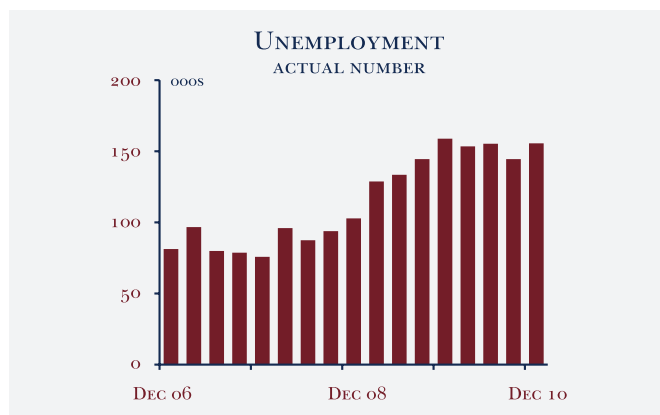
The IMF is emphasising the need for repairing and reforming the financial sectors in advanced economies to ensure the 'right kind' of recovery. Such a recovery would also prevent overheating in developing countries through moderating capital inflows and therefore reduce inflationary pressures.

Employment growth positive but patchy

Employment in December 2010 was 28,000 higher than in December 2009. This was the untold story in the latest release of labour market statistics. Rather, headline numbers preferred to focus on the rise in the unemployment rate and its closeness to the peak reached during the recession.

Of course, seasonal factors are a strong influence in actual unemployment numbers rising in the December quarters. In particular, a lot of young people have just completed study at school and/or tertiary education and training institutions and have not yet got a job.

So, unsurprisingly, the actual number unemployed in December was 155,600, which was more than the 144,500 unemployed in September 2010 – but 3,300 less when compared with December 2009.



The exodus of students during the December quarters can also potentially cause a large increase in the number 'staying at home' and reporting themselves as Not in the Labour Force. This category can spike upwards considerably if job market options are perceived by job seekers as limited. This category increased by nearly 20,000 in the year to December, which is a lot less than the 46,000 increase in the number who 'switched off' from work during the December 2009 year.

The employment growth of 28,000 more people employed over the past year included surprisingly strong growth in full-time employment by 40,000 jobs, and a loss of 12,200 part-time jobs. These part-time job losses appear to reflect cutbacks in some of the social services as there were over 8,000 lost in areas of education and over 4,000 in health care services.

A really positive signal is the increase in employment in the manufacturing sector. This increased by 17,500 in the year to December 2010. This is the largest increase in employment for this sector since the low exchange rate experienced after the recession of the early-1990s.

Employment growth was also quite widespread amongst the industries within the manufacturing sector. Noting that the manufacturing sector also includes the food processing industries, there was increased employment in food and beverage products, wood products and fabricated metal products.

Outside of manufacturing, other sectors with employment increases were parts of retail trade, professional services, and the arts, recreation and other services. There were substantial job losses in the social services and finance and insurance services sectors.

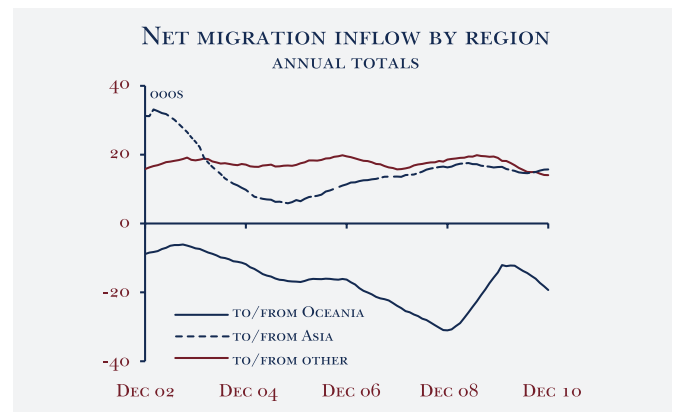
A telling factor statistic was the lack of significant job growth in the construction industry. Clearly, the Canterbury re-building effort post-September had yet to gain momentum. This reinforces the significant challenges facing the now much larger re-build required.

Migration stuttering along

Net migration (i.e. arrivals less departures) remained positive in calendar 2010, with a net inflow of 10,450 people. This is well down on the 21,250 recorded in 2009, but is still a positive number that is providing some stimulus to the economy.

The gross total of departures of New Zealand citizens to Australia has bounced back from a low of 28,600 in 2009 to 32,200 in 2010. The other main increase in outflows was about 3,000 non-New Zealand citizens leaving for countries other than Australia.

The gross inflow has been declining also, with reductions in New Zealand citizens and other arrivals.



In net terms, the largest turnaround is in the increase in the overall net outflow heading to Australia and other parts of the Pacific (as illustrated in the chart).

In total, though, the arrivals are still great enough to exceed the departures, by 10,400 people. So, despite our difficulties in offering competitive salaries, New Zealand remains a relatively attractive place for many migrants and potential migrants.

Mood was flat, but now our world has changed

Notwithstanding an eventful two months on world markets since our December issue of BERL Forecasts, the domestic situation was relatively unchanged from that time. Before the earthquake last week, the 90-day interest rate remained at or near 3.17% and the TWI as virtually unchanged at 68.0, albeit highly volatile throughout the period. GDP and other indicators of the real economy continue to come in well below official forecasts and our expectation that the OCR would remain at 3.00% up to June, and likely beyond, has become the consensus.

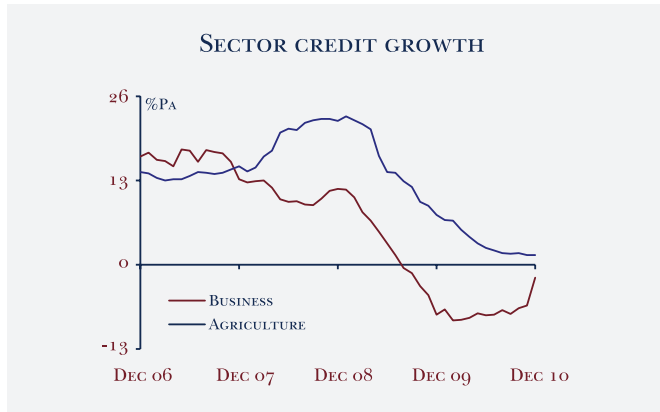
The most disconcerting aspect is the negative GDP for the September quarter 2010 and the possibility of a double-dip recession. From a monetary policy perspective, the justification for the Reserve Bank's decision to begin raising the OCR in June 2010 followed by another rise in July looks decidedly suspect especially since at that time GDP was actually shrinking.

The problem in our view is not only that individuals and firms have retreated into a mood where consumers are focused on saving and debt reduction and firms are afraid to invest. This is as the Reserve Bank and financial system generally portrays the situation. But, in reality the economy as a whole is deleveraging from the excess indebtedness incurred in the run-up to the 2008 crash. Not only are individuals deleveraging from excessive indebtedness but so are the banks.

While it may be necessary for individuals and firms to change their state of mind to get the economy going again, it is not sufficient if the financial sector is still deleveraging.

Whether the basic problem is with households and firms, with banks, or with both, the outcome is the same; credit expansion is at an extremely

low rate and not conducive to positive growth. Thus, in the two-year period ended December 2010, domestic private sector credit expanded at a rate of 0.1% a month compared with 0.7% for the whole period of the dataset. This is unprecedented in New Zealand's post-WWII history. Even in the difficult times of the late 1980s and early 1990s monthly rates of expansion were never down below 0.4% for extended periods.

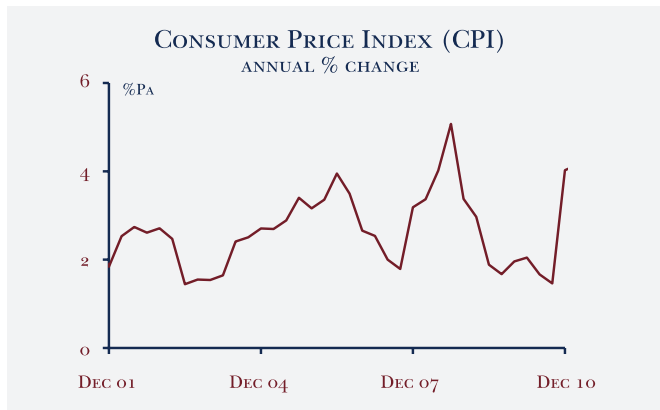


The events of the past week have changed all this. The 90-day interest rates have fallen 30-basis points to 2.86%, while the TWI has declined to just around 66.

The short-term response is likely to see an OCR cut announced in March, although its immediate impact is likely to be on sentiment rather than activity. The detail of the re-building programme ahead remains uncertain – and likely to remain so for some time, as the status of buildings and infrastructure are yet to be fully established and understood. Thereafter, once the extent of the task is fully comprehended, the recovery will have to be seen in a far more longer-term perspective. Meanwhile, the “elephant in the room” remains in the form of tight credit conditions (globally and domestically) that cannot be ignored.

Inflation passive despite GST spike

Inflation remains subdued once the October GST spike has been taken out of the equation. The 2.3% rise on the December quarter and the 4.0% rise on the December year includes the impact of the GST increase, which was expected to add around 2.2% to the CPI. Taking that away suggests annual CPI running at around 1.8%.



The fact that food prices have shot up in the January month, is no cause for panic, as this is usually the case in a January month when fruit and vegetable prices tend to peak. In fact, the 1.8% increase on the month was lower than the 2.1% increase in the same month last year. As expected, the main driver of price increases was fruit and vegetables, which were 7.4% up on the previous month.

Food prices are up 3.8% on the year. Annual increases have declined since October and will continue to do so as the GST spike works through the calculations. This should bring annual food prices back to the 2.0% range.

The weak economy will continue to suppress price increases in the near term, and the poor performance of the housing market leads us to believe that domestic spending will remain subdued.

The Producers Price Index and the Capital Goods Price Index for the December quarter will be released shortly and this will give us further insight into inflationary pressures.

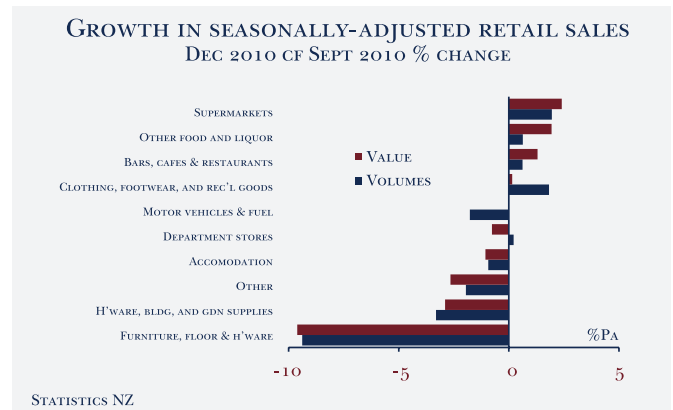
Retail sales and volumes remain subdued

Retail sales remained subdued in the December quarter of 2010. Nationally, retail turnover held its ground in the December quarter, falling by a negligible 0.1% in seasonally adjusted terms. As expected, volumes fared slightly worse, dropping by 0.4%.

The greater drop in volumes over values is further evidence of price reductions and margin cutting in recent months in some industries. In the core retail trade industries, eight out of the 13 sectors reported the value of sales growing by less than the volume over the December quarter, indicating price falls (and/or margin cutting) in these sectors. Of these sectors, the largest price reductions were in the clothing and footwear sector, with prices also significantly down in the electrical and electronic goods sector as well as the recreational goods sector.

Sectors continuing to experience price increases were supermarkets and grocery stores, specialist food stores, liquor stores and the food and beverage service sector.

In the automotive industries, rising fuel prices dominated, with a 3.8% increase in the price index for the fuel industry over the three months to December.



Scanning across the country, only Auckland saw an increase in seasonally adjusted sales in the December quarter, and this was a modest 0.2% rise. Given the industry as a whole experienced deflation however, the rise in values was unlikely to be matched by a rise in volumes. However, the price index data is not reported at a regional level, so we cannot confirm this from the officially reported statistics. The Waikato and provincial North Island saw greater falls in sales, of -2.7% and -1.9%, respectively, while Wellington and Canterbury remained flat.

Building activity continues to falter

December 2010 saw only 994 new residential building consents authorised across the country. This was the lowest December total since the start of this series in April 1965.

The total for the 2010 calendar year came in at 15,602, an improvement from the annual total of 14,425 in 2009. New house consents in the North Island were 7.3% higher in 2010 than in the previous year, while in the South Island new consents were 11.4% higher. However, these two years have recorded amongst the lowest totals for new house consents over the past 45 years. Indeed, the 2009 total was the lowest since 1966, while the 2010 total was the 42nd lowest.



RESIDENTIAL BLDG CONSENTS
DEC 2010 QTR % CHGE ON YEAR EARLIER



STATISTICS NZ

And while the annual total for 2010 was up on 2009, the latest three months indicates a further retreat. Nationally, the December quarter (influenced by that historic low in the December month) was 16% down on the same period a year earlier. As the chart illustrates, this decline was felt across almost all regions, with significant declines experienced in Otago, Taranaki, Manawatu-Whanganui, Hawke's Bay and Northland.

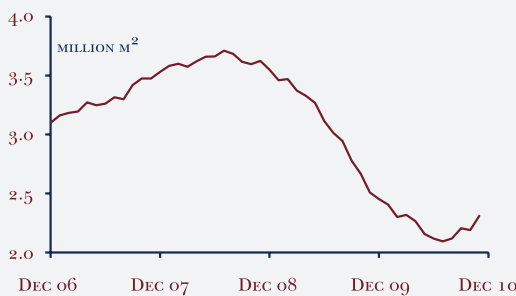
In the three months to December, the number of non-residential building consents authorised was 3,279, about 1.5% below year-earlier levels.

Within the sectors, the largest declines were in the number of consents issued for farm buildings, social and cultural buildings and education buildings – with consents almost 10% below year-earlier levels. Also noticeably down were consent numbers for hostels and storage buildings.

In terms of the floor area of the consents issued, the overall total indicated a promising level in the December quarter of more than 9% up on year earlier. However, the total for calendar 2010 remained more than 8% below that of 2009. In office buildings the consented floor area declined 34%, with a 16% decline for social buildings and 10% for farm buildings.

These consent numbers, across almost all sectors of the construction industry, confirm the ongoing weakness of building activity.

NON-RESIDENTIAL BUILDING CONSENTS
FLOOR AREA 12-MONTH TOTALS



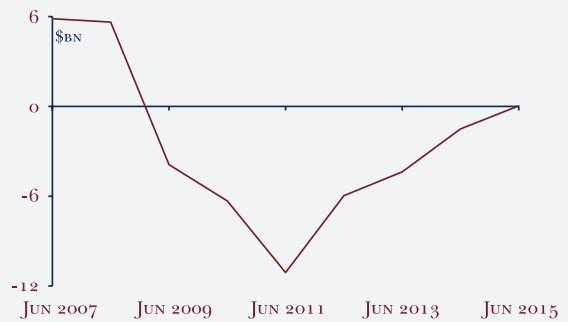
Government accounts holding the line

The latest Government's Financial Statement suggested the books were under control, in the sense that the tax take was stabilising and the deficit was on track with longer-term forecasts.

For the full year (financial year ending June 2011), the Treasury was expecting the OBEGAL (operating balance excluding gains and losses) to reach \$11.1bn. This translates to a cash deficit of the order of \$15.6 bn. This latter figure equates to the widely quoted \$300m per week that the Government needs to fund through borrowing.

As the chart illustrates, the Treasury expected the Government accounts to return to balance in the financial year to June 2015. This was indeed a challenging forecast, assuming a rapid recovery from the recession.

TREASURY FORECAST FOR OBEGAL



While Budget balance by 2015 would have been the aim for this year's Budget announcements, the impact of the Canterbury earthquakes will certainly cause a re-think.

In terms of financial position, the Government's gross debt as at 31 December stood at \$62bn, which represents just over 32.5% of annual GDP. Translating to net debt, the figure becomes \$40bn or nearly 21% of annual GDP.

It should be clear that, in proportionate terms, this level of debt is not large either historically or in comparison with other countries. For example, the level of Government debt was close to 40% of annual GDP during the early-1990s. And countries at the centre of the sovereign debt crisis in Europe (e.g. Greece) had debt levels well above 100% of their annual GDP.

However, the Government's debt, in conjunction with the private sector's much more precarious debt situation, highlights the nation's vulnerability in the face of much tighter global credit lines.

Consequently, the Government's Budget announcements will need to strike a careful balance between the very real and pressing need for nation-building and the very real constraints on financing.

How the Government confronts this challenge is likely to shape the prospects for the New Zealand economy into, and well beyond, the medium term.

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