

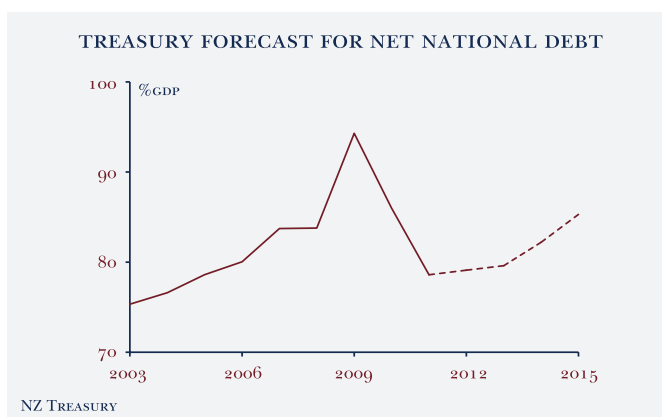


# BERL Monthly Monitor

May 2011

## A Budget Statement for a country going nowhere

The 2011 Budget was disappointing. The lack of focus on the nation's debt problem reflected the seeming reluctance of advisors, officials and leaders to own and/or confront the nation's challenges. Rather, the simpler task of reining in the Government's debt was kept in the spotlight. With many applauding the early return to surplus and consequential faster reduction in Government debt, the worsening national debt situation seems to have escaped largely unnoticed.

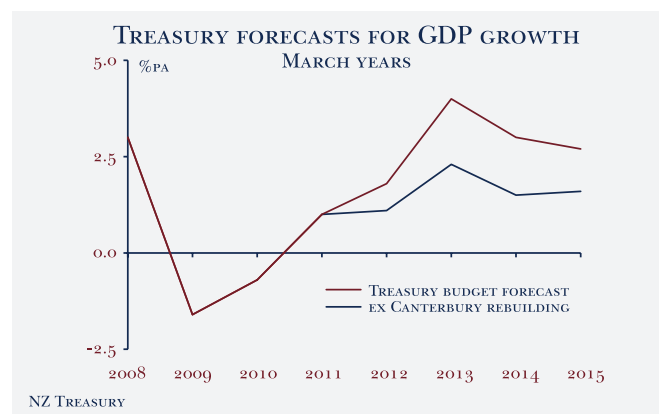


Meanwhile, the forecast deterioration in our external indebtedness is consistent with the picture of an economic cycle underpinned by rebuilding Christchurch. While this is understandable, the lack of significant other economic growth over the forecast horizon paints a sombre picture. The rebuild effort is accompanied by a lift in private sector investment spending. However, this rebuilding programme and associated activities are forecast to divert resources away from other sectors, including the export sector. Coupled with the relatively high import composition of investment spending, a further deterioration in our external trade balance is forecast. This is despite the relatively high commodity prices and terms of trade expected over the period. These factors, of course, translate directly to a worsening of our foreign indebtedness.

The numbers are stark. Export volumes growth over the next four years (from the year to March 2012 to the March 2015 year) is expected to average 2.6%pa. In real terms, this means the export sector remains at just under 34% of national economic activity – equivalent to its proportionate share in 2003. In contrast, import growth in volume terms will expand by 4.5%pa over these four years, seeing the current account balance balloon to a \$16.8bn deficit in the March 2015 year. This represents an imbalance to the tune of 6.8% of annual GDP, which is not much progress on the pre-crisis 7.8% deficit recorded for the March 2008 year.

And the sucker punch? All the above combines to see our net international debt position for March 2015 forecast at 85.3% of annual GDP, which is actually worse than the pre-crisis level of 83.3% registered for March 2008.

Some may suggest that this is driven by the need to divert resources to the investment surge and associated imports needed to rebuild Christchurch. But the investment surge is not expected to be that impressive. Indeed, the two years of forecast double-digit growth (in the years to March 2013 and March 2014) is noticeably weaker than the three years of double-digit non-housing investment expansion witnessed between the March 2004 and March 2006 years. Further, the expected residential building surge, translates to about 22,500 new houses forecast to be built in the March 2013 year, and just under 26,500 in the following March year. Neither of these figures, when viewed in a historical context, suggest a substantially large house building programme across the country.



The point is that the investment surge needs to occur along with ongoing economic growth across all other sectors, industries and regions. Transferring resources away from exports and other investments in order to rebuild Christchurch risks magnifying our long-term economic imbalances. Postponing our economic targets and goals by hiding behind the need to rebuild Christchurch is little short of acknowledging defeat – a sign of a somewhat myopic outlook consistent with a nation aimlessly stumbling through one economic cycle and on to the next. The time to galvanise a nation – behind, not just a rebuilding programme; but behind economic activity focussed on growing incomes and opportunities for present and future generations – is clearly now.

But, with a focus on textbook metrics of fiscal prudence, it seems we really are destined to go nowhere.

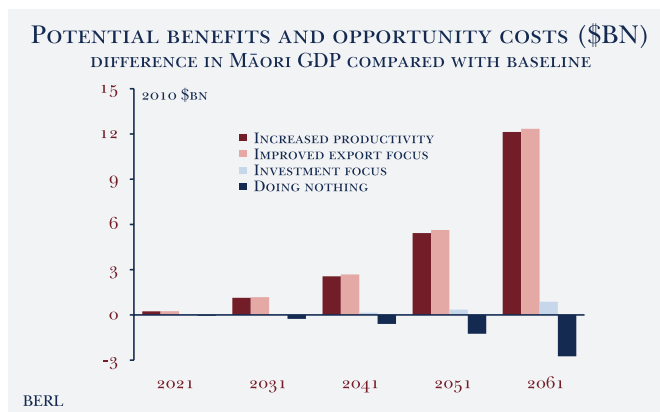
## Potential waiting to be tapped in Māori economy

Recently completed research by BERL has estimated the asset base of the Māori economy to be \$36.9bn, reflecting growth of some 4%pa over the past four years. As was previously known, this asset base remains relatively concentrated in the primary agriculture, fishing and forestry sectors. However, this latest study undertaken for the Māori Economic Taskforce and Te Puni Kōkiri particularly notes the widening of the asset base across other sectors. Activities in tourism and tourism-associated retail, accommodation and hospitality, as well energy, manufacturing – including primary product processing – construction, and the provision of education, health and social services are noticeably significant.

Also highlighted by the study was the importance of non-collectively owned assets. The \$36.9bn total comprises:

- \$5.4bn of assets attributable to the enterprises of nearly 12,920 Māori self-employed.
- \$20.8bn of assets attributable to the enterprises of 5,690 Māori employers.
- \$10.6bn of collectively-owned assets in various structures including Māori Trusts and Incorporations, Organisations, Boards, entities and Iwi/Rūnanga holding companies and other entities.

The study also generated a set of scenarios for the future development of the Māori economy. The motivation for these scenarios was to question whether there were gains to be made if our science, R&D and innovation efforts were more closely aligned to the efforts of Māori entrepreneurs.



A combination of information and communication difficulties, fractured land holdings, lack of scale, capability and capacity issues, along with unclear governance and management arrangements currently make this alignment frayed, at best.

From the four scenarios modelled, we concluded that there are significant potential benefits arising from a better alignment, and a genuine engagement, between the nation's science and innovation effort and businesses in the Māori economy. However, a reluctance to address the current misalignment would lead to significant opportunity costs being incurred.

In the best case scenarios, the science and innovation effort is successful in lifting the productivity of assets in the Māori economy, as well as increasing the export focus of Māori businesses. This results in GDP from the Māori economy

in the 2061 New Zealand economy being more than 22%, or \$12bn in today's real dollar terms, above the 'business as usual' or baseline outcome. However, a 'do nothing' scenario sees GDP from the 2061 Māori economy some 5%, or \$3bn, lower.

A further scenario postulates that investment spending on science is lifted, but there is little alignment between the science and innovation effort and Māori businesses. This yields marginal benefits to the Māori and the New Zealand economy, but does not deliver the desired step change.

We concluded there was compelling evidence of the need for an effort to develop a genuine relationship between the science and innovation sector and Māori businesses to realise potential opportunities through leadership and collaboration to build capacity, capability and scale.

## Tourism and migration numbers continue in retreat

A total of 2.5 million people visited New Zealand for the year ending March 2011, bringing them back down to tourist numbers last experienced in 2008. Tourist numbers for March have declined to just 215,500, down 11% compared to March last year.

The significant decline in tourist numbers is somewhat influenced by the high New Zealand dollar and to a lesser extent the later timing of Easter and the Australian School Holidays.

Even when tourist numbers were seasonally adjusted to take into account the school holidays, numbers had declined by 7.1% since February, and has been falling since January.



In March, tourist numbers from New Zealand's two largest markets, Australia and the United Kingdom, were down. Australian tourists dropped by 11,904 (11.3%) from March last year, while UK tourists dropped by 6,822 (25.8%). However, there were slight rises in tourists coming from USA and China with US tourists up 1.2% and Chinese tourists up 7.1% from March last year.

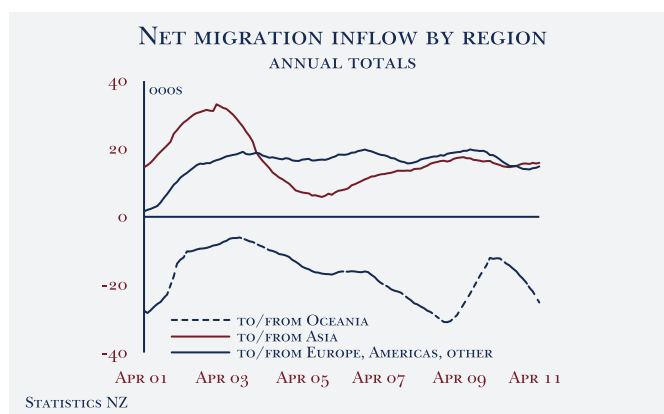
Large falls were felt from Japan and South Korea, where tourist numbers are down 35.1% and 38.1% respectively from March last year. The effect of the earthquake and subsequent tsunami has undoubtedly caused the drop in Japanese tourists and will likely be felt for some time. The large dip in Korean tourists is not unusual for a market characterised by its volatility.

Drops in visitor numbers were anticipated, and with tourism expenditure showing declining trends, this paints a rather bleak picture for one of New Zealand's biggest earners. However, declines in tourist numbers are expected to lift before the Rugby World Cup in September and October this year.

Net migration (i.e. arrivals less departures) has also declined. For the year ending March, only 6,600 people came to New Zealand, significantly down from the year ending March 2010 where net arrivals were 21,900. The decline in migration was caused by a modest decline in arrivals, down 2% from the year ending March 2010, and a large 21% increase in departures.

Looking at migration from specific countries, most net arrivals were from India (6,000 net arrivals), the United Kingdom (4,900 net arrivals) and China (3,900 net arrivals).

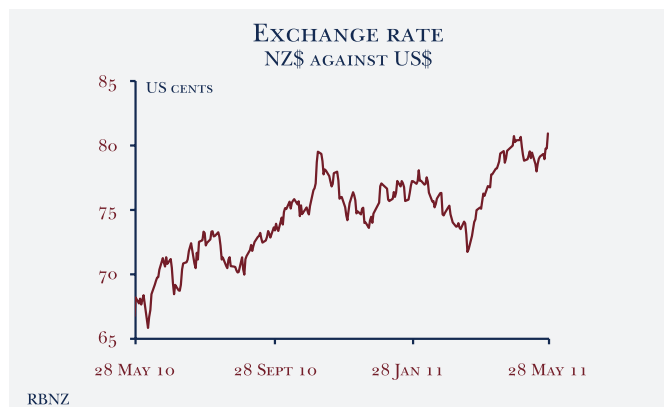
However, as you can see in the graph below, these net arrivals have been more than offset by large net departures to Australia. For the year ending March 2011, 25,300 left New Zealand to go to Australia, 10,500 more than in March 2010. Most of these departures were from New Zealanders taking advantage of the strong Australian economy.



## Commodity prices and interest rates keep NZ\$ and A\$ strong

The New Zealand currency continues to go from strength to strength against the US currency, with the NZ\$ averaging around 78 US cents in April 2010.

More recently, the NZ\$ hovered around the 79 US cents mark in anticipation of the 'zero Budget'. In the immediate wake of the Budget, the NZ\$ remained quite stable. It seemed that the Government's forecasts of reductions in government debt from 2015 have satisfied the credit rating agencies. In particular,

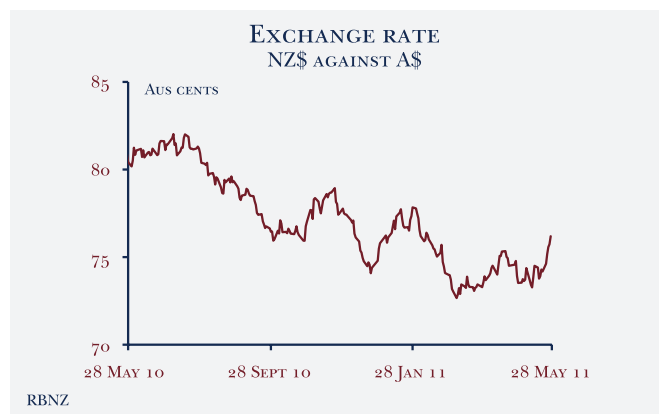


Standard and Poors and Fitch have left their credit rating unchanged. Any decrease in New Zealand's sovereign credit rating could lead to a weaker NZ\$ as its perceived level of risk is raised, as well as leaving NZ open to higher interest rates. However, New Zealand remains on negative watch as total external debt, which includes both Government and private debt, is still forecast to worsen.

The conventional argument for the ongoing strength of the NZ\$ is strong global commodity prices. In particular, dairy, wood pulp, timber, beef, wool exports and apples are all experiencing higher prices according to recent releases of the ANZ commodity price index. This index hit an all time high in April. The booming growth of China, India, and other countries in the Asian region with accompanying strong demand for food and raw material products, are set to work in New Zealand's favour for some time to come.

The financial situation of other countries is also a factor helping explain the strength of the NZ\$. In particular, large budget deficits in the US and EU along with rising government indebtedness has seen investors search for alternative options for their funds. In addition, higher interest rates in New Zealand are another factor. The IMF released a statement in early May stating that the NZ\$ is over-valued by up to 20% because of New Zealand's relatively high interest rates.

However, the ongoing strength of the NZ\$ has been more than matched by that of the Australian currency. In particular, the A\$ is close to US\$1.10 as Australia's strong economy, relatively high interest rates, and much needed mineral deposits have kept its dollar high. As a consequence, the NZ\$ has remained well below 80 Australian cents over the past year, a long way down from the 90 Aussie cents the NZ\$ dollar used to fetch in 2005.



Of course, the strong A\$ is good news for NZ enterprises reliant on the Australian market (e.g. parts of manufacturing and tourism); but is particularly bad news for New Zealand consumers and holidaymakers as Aussie imports and holidays across the Tasman become more expensive.

## But finance sector rebalancing continues

News over the weekend that the Moody's agency has downgraded the credit rating of New Zealand's four main trading banks should come as no surprise. We might add that we were probably surprised that it hasn't come earlier. The significance of this downgrade should not be overplayed as the ratings remain relatively high at Aa3. Conversely though, the reasons for such a downgrade should not be glossed over, as



they continue to reflect the ongoing funding pressures within our financial sector.

The principal reason given was that it was in line with the similar downgrade of their Australian parents announced earlier.

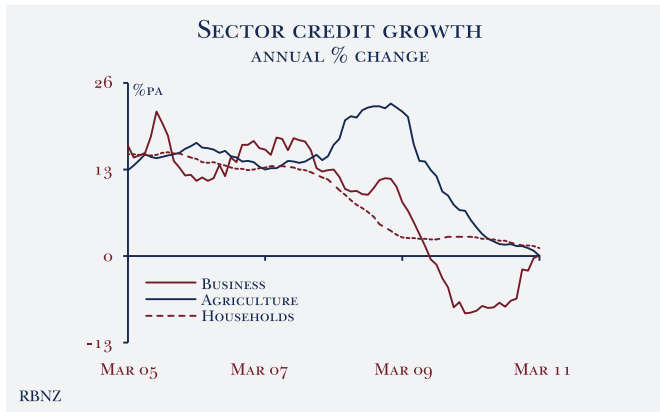
But, factors specific to New Zealand are highlighted in Moody's announcement. In particular:

*"The 1-notch downgrade ... reflects the ongoing impact of the challenging economic environment in New Zealand ... The local economy remains subdued, with GDP growth now forecast to show stronger growth in the year to March 2013, a year later than forecast last year ..."*

*"New Zealand major banks are structurally sensitive to wholesale funding market conditions. The major banks have around 40% of their total funding base sourced from wholesale funding, with around two-thirds of this being sourced offshore."*

*"Over the past 6-months, the major banks have enjoyed relief in funding pressure due to slower loan growth and higher customer deposit growth. The increased savings rate was supported by lower credit and consumption growth combined with moderate income growth. However, we believe this dynamic is not sustainable in the long-term."*

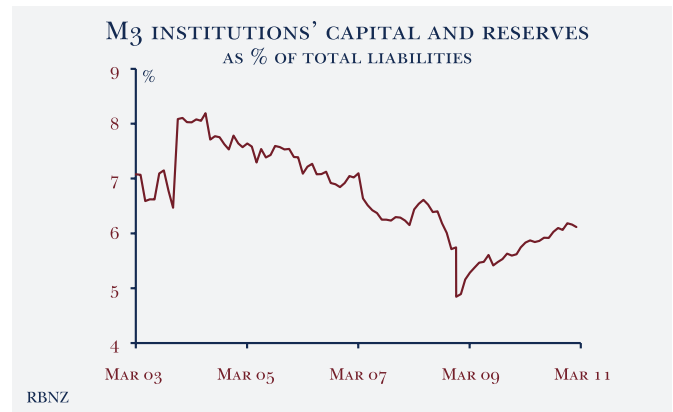
The last sentence suggests that Moody's are not convinced that our alleged change in savings behaviour will last much past the latest downturn. We remain similarly sceptical. But, we would prefer our focus to shift to earning income as a nation, as opposed to trimming spending in an attempt to save more out of globally uncompetitive earnings.



As to the latest credit statistics, they continue to reinforce just how tight monetary conditions in New Zealand remain. The growth in credit available has now stalled to be close to 0% on year-earlier levels across all sectors, as illustrated. For the non-agriculture business sector this follows more than two

years of contraction and means the level of credit is still below the level recorded in March 2008. For the agriculture sector credit growth has plummeted from double-digit levels a couple of years ago to also now be at no change on year earlier. Growth in credit to the household sector has also declined, although not as dramatically, to be now close to zero.

Despite this slower loan growth, the rebalancing of the finance sector's balance sheets remains slow and gradual. As the chart indicates, the sector's stock of reserves remains only marginally above 6% of total liabilities, well below the previously accepted (Basel I) benchmark of 8%. This follows the unsustainable decline in this ratio through the 2004 to 2008 period, before a precipitous plummet at the onset of the Global Financial Crisis.



The two charts in this section amply illustrate the financial constraints on the national economy, and the likely continuation of these constraints over the near term. More sobering are the comments from Moody's suggesting continued structural difficulties with funding New Zealand's financial sector. In particular,

*"Despite recent improvements in wholesale funding reliance, a significant shift in the bank's funding profiles towards customer deposits is restricted by New Zealand's limited customer base ..."*

*"New Zealand has a population of around 4.3 million which is growing at only 1% per annum, placing a ceiling on retail customer deposit growth. Corporate and institutional deposits are also limited due to New Zealand's smaller economy."*

To us, these comments reinforce our conclusion that the short-term focus on savings and debt is a narrow cul-de-sac with little appeal. Rather, for New Zealand to move forward towards a sustainable, properly re-balanced economy, there needs to be a positive spotlight on earning export incomes to grow high-skill and competitive job and business opportunities into the long term.

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