



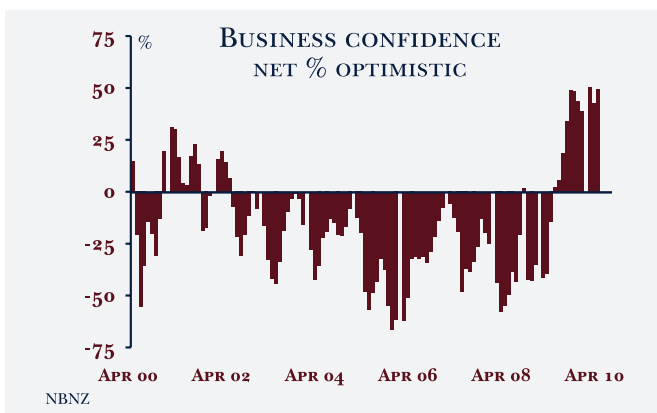
BERL Monthly Monitor

April 2010

Recovery numbers look exciting, but beneath the headlines ...

The New Zealand economic recovery is picking up momentum, with many headline numbers looking on the bright side. However, beneath the headlines the composition of the recovery in growth is not so bright.

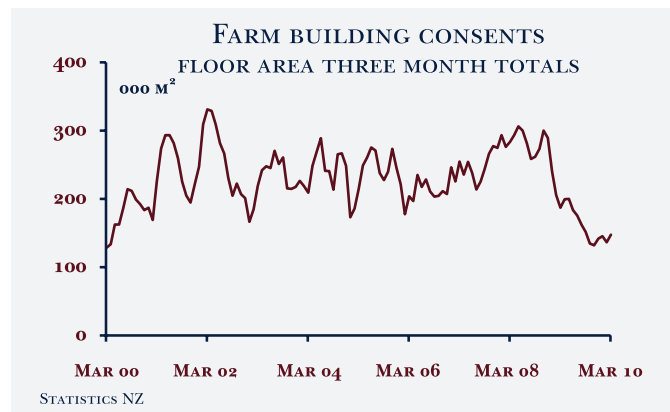
For example, the net 49% positive response in the National Bank survey asking whether the economic situation will get better or worse over the coming 12 months is indeed promising. But, without putting too much of a dampener on this, this could just as appropriately be interpreted as reflecting the notion that that the next 12 months can't be any worse than the previous 12 months. According to this same indicator a significant majority of respondents were pessimistic over prospects for the economy for the seven years from mid-2002 to mid-2009 – despite employment expanding over the same period by an average 39,000 annually (a rate equivalent to 2%pa). Rather than argue over whether the glass is half full or half empty, a few more indicators are worthy of inspection.



Prospects for the house building industry have recovered dramatically, so that residential consents issued over the first three months of this year are more than 32% up on year-earlier levels. This takes the total for the March year to just under 15,400, which is not far off the 16,200 recorded in the March 2009 year. This rapid turnaround, linked to the underlying housing supply shortage and the net migration inflow, sees activity on track to reach well over 17,000 residential consents for calendar 2010.

However, the flip side of this story is the non-residential sector. In line with the plummet in business investment spending (as below), non-residential consents in the first three months of 2010 are well below year-earlier levels. Whether measured in terms of number (down 5.4%), or

value (down 17.9%), or square metres (down 19.0%), this sector faces a bleak outlook. Further, within this overall number are some large collapses in investment spending. Amongst the larger categories, farm building consents are down 21% (in square metre terms); factories and industrial buildings down 44%, office buildings down 29% with the shops and restaurant category down 24% and storage buildings down 9%.



We don't see a rapid recovery in non-residential building numbers as many firms continue to concentrate on reducing debt obligations, while tighter loan criteria are likely to deter others from embarking in new building activity.

Migration and tourism figures holding up

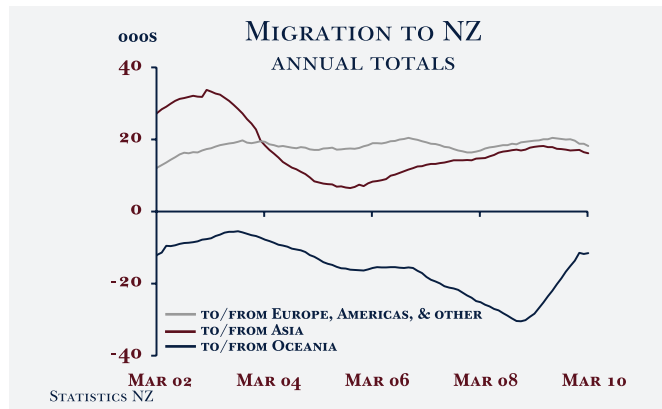
On the plus side, migration statistics are holding up, despite the renewed attractiveness of Australia. The first three months of this year saw a net inflow of permanent and long-term migrants of just over 4,800, similar to the 5,100 recorded over the same period a year ago. This figure takes the annual net inflow to just under 21,000, well up on the 7,500 for the previous March year.

This annual inflow continues to be made up of a relatively stable net annual inflow from Asia of the order of 16,000, and from Europe and the Americas of about 18,000. Both of these inflows have turned down marginally over recent months, but not dramatically so. On the other side of this equation, the large net outflow to Oceania (predominantly to Australia) has shrunk dramatically over the last 12-15 months. Noticeably, however, this decline appears to be stabilising around a net outflow annual figure of 12,000.

As noted earlier, a total net inflow of around 20,000 per annum would continue to provide impetus for the

turnaround in the residential building. However, the prospects of significant and ongoing economic (and income) growth in Australia could see a resurgence in the migrant outflow across the ditch. We see inflows from other regions continuing at relatively positive levels as, in particular, the US and European economies stutter in the face of ongoing financial imbalances and instability.

The tourism sector has also weathered the economic storm remarkably well, clearly helped by the buoyant Australian visitor. Visitor numbers in the first three months of the year were a healthy 5.6% up on year-earlier levels, with a 13.2% increase in tourists from Australia reinforcing the importance of this market. Falls in visitors from our second-largest and third-largest markets (UK down 2.8% and US down 2%), further highlights our apparently growing dependence on the fortunes of the Australian economy. This divergence is likely to continue over the short term, at least, given the relative favourability of the NZ\$/A\$ exchange rate, compared to the relatively unfavourable NZ\$/US\$ and NZ\$/€ rates. On a further positive note, the annual total number of tourists is now just a shade under the iconic 2.5m mark (4% up on those of a year ago).



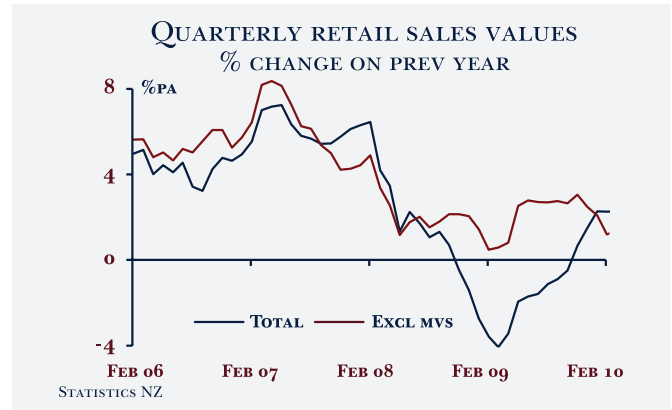
Domestic consumer remains wary, helping restrain import figures

As for the consumer, a quick look at new car registrations data also suggests the worst is over, with numbers for the first three months of this year about 25% up on year-earlier levels. However, the extremely low numbers registered in the early months of 2009 need to be noted. Consequently, the total for the year to March remains 10% below those of the previous year.

This is reinforced by retail sales numbers, which show turnover being flat, at best. Core sales – which exclude vehicle related sectors – in the three months to February 2010 were 1.1% up on year-earlier levels. Allowing for inflation, this indicates that real retail sales volumes are still shrinking.

Including the motor vehicle related sectors, the picture for retail sales reveals an increasing rate of expansion over recent months. However, as noted above, this trend is exacerbated by the depths of the contraction experienced in early-2009.

We expect the consumer to remain wary as employment and income prospects remain uncertain, and interest rates begin to climb from their relative lows. Income tax relief on the horizon may assist the Christmas spend this year, although the balancing impact of the GST rise will likely impact on the timing rather than level of consumer expenditure.



A plus arising from the domestic contraction is a dramatic turnaround in the nation's deficit on the current account of the Balance of Payments (BoP). The \$5.5bn deficit for calendar 2009 is in stark contrast to the \$16bn deficit recorded in 2008. An improvement from 8.7% of GDP to under 3% of GDP in one year would, under normal circumstances, be an achievement worthy of celebration. Unfortunately, the majority of this improvement arises, not because NZ has earned increased income. Rather, the improvement results from a contraction in economic activity depressing consumer and investment spending and a consequent reduction in imports. Indeed, the BoP figures show a 7.4% fall in export revenue, but a 14.9% reduction in the import bill.

Consequently, the last three months of 2009 saw a slight improvement in our net international indebtedness – from a net debt figure equivalent to 93% of annual GDP as at September to only 90% of annual GDP as at December. This comprises gross assets totalling 76% of annual GDP (equity 29% and lending 47%), outweighed by gross liabilities the equivalent of 166% of annual GDP (equity of 35% and borrowing of 131%). Noticeably, the gross borrowing requirements have eased through the year (the 131% was close to 140% in early-2009), which has been reflected in a decline in banks' gross borrowing inflows (from 87% to 81% of annual GDP).

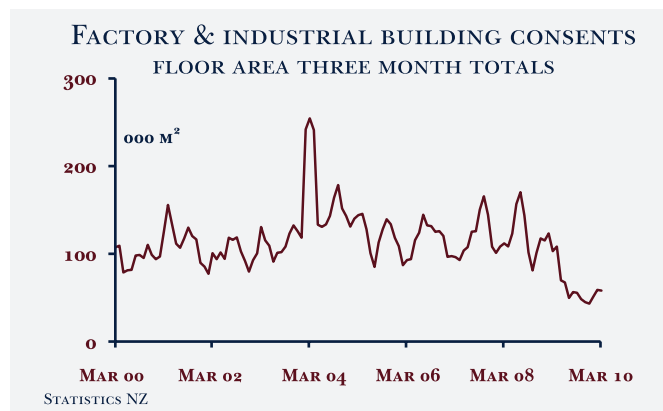
Headline GDP promising, but ...

As to the GDP numbers, growth of 0.8% in the economy in the December quarter would, again, under normal circumstances qualify as exciting. However, closer inspection suggests our excitement should be tempered. Firstly, as a reflection of just how low we are starting from, the 0.8% growth means that production in the 2009 year was still 1.6% below that of the previous year.

Secondly, the composition of growth was patchy. Quarterly growth of 4.4% in manufacturing was a welcome sign of life in this sector. Wholesale trade, retail

trade & accommodation, and agriculture were also high on the growth ladder, but growth was noticeably absent across many other sectors. In particular, construction registered another quarter of contraction; activity in the non-agriculture primary industry also fell; while transport, finance & business services and personal services activity levels sat at no change. On an annual basis, despite the surge over the last quarter, activity in manufacturing in 2009 averaged 10.5% below that of the previous year, while construction slumped 8.5%.

Thirdly, the scariest number for the quarter was the 6.1% contraction in private sector business investment. This is clearly consistent with cash flow and constrained credit conditions, but provides little evidence that businesses are gearing up for a strong upswing. This quarterly decline has resulted in business investment over 2009 slumping 17.8% on that of the previous year, remembering that this category excludes government and residential investment. That is, indeed, a sobering outcome and does not bode well for the state of productive resources (and, so, productivity gains) in the coming period.

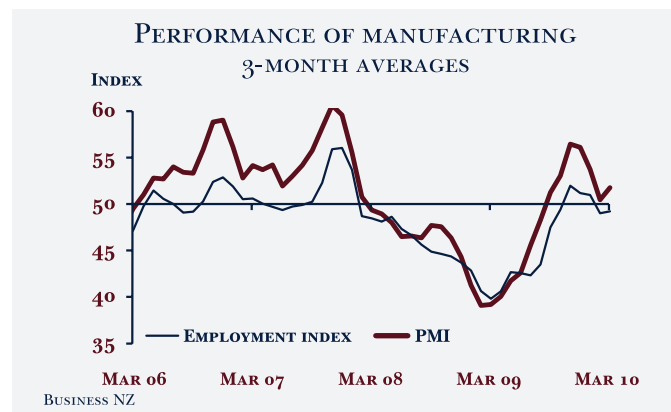


Fourthly, the export figure was not promising, with a quarterly fall of 0.9% belying the idea that the recovery is based on a shift towards the export sector. Admittedly, this number takes exports for 2009 to a level equivalent with that of the previous year. However, this figure is heavily driven by expansion in two export categories – dairy (up 27.6%) and primary forestry products (up 34.4%) – with noticeable contractions in metal products, machinery & equipment (down 10.3%) and service exports (down 6.2%).

Manufacturing activity begins to expand

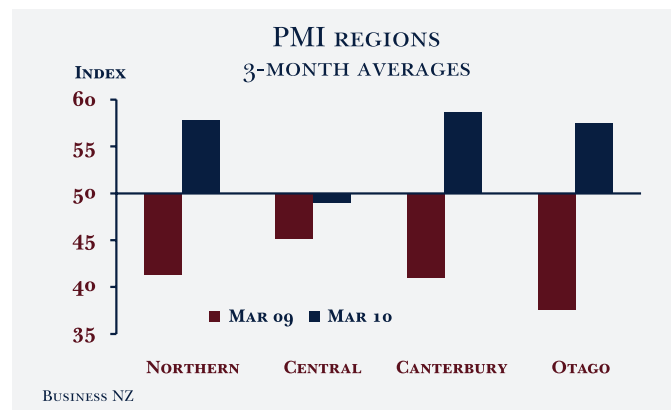
Manufacturing activity is expanding. The Business New Zealand Performance of Manufacturing Index (PMI) stood at 56.3 in March, while the latest New Zealand Manufacturers and Exporters Association Survey of Business Conditions completed during March showed total sales in February increased by 1%.

The PMI result this month is a marked improvement – up from the 53.3 recorded in February and 52.0 recorded in January. As an early indicator of manufacturing activity, the PMI is at its highest level of overall activity since November 2007, remembering that a PMI reading above 50 indicates manufacturing activity is expanding.



All five of the seasonally adjusted sub-indices measured recorded above-50 numbers. Production recorded the highest value at 59.4, followed by deliveries at 57.0, new orders at 56.9, finished stocks at 52.8, and employment at 50.1. Looking at seasonally-adjusted indices between February and March, the production index increased by 6.1 points, the deliveries index increased by 4.1 points, while the finished stock index increased by 2.5 points. The employment index also stayed above 50 for the second month in a row, but it continues to have a poor result compared to the other sub-indices. We expect the employment index to stay in the low 50s throughout most of 2010, with the labour market lagging and further job losses potentially occurring throughout 2010.

The three-monthly average for the PMI improved slightly in March to sit at 51.4, up from the 50.1 recorded in February, but down from January. All three quarterly average indicators have improved, with production showing the strongest result. Over the last three months, employment has averaged 48.9, a slight increase from previous quarters.



Turning to the regions, there were mixed results. The Northern (57.8), Canterbury (58.6), and Otago (57.5) regions recorded expansions in activity (i.e. index numbers above 50), while activity in the Central (49.0) continued to contract. Indeed, the Central region is yet to record an above-50 index in 2010.

Overall, the outlook for manufacturing remains grim. Short-term relief is in sight for those parts of manufacturing exporting to the Australian market, as the NZ\$/A\$ exchange rate becomes more favourable. However, the sector is

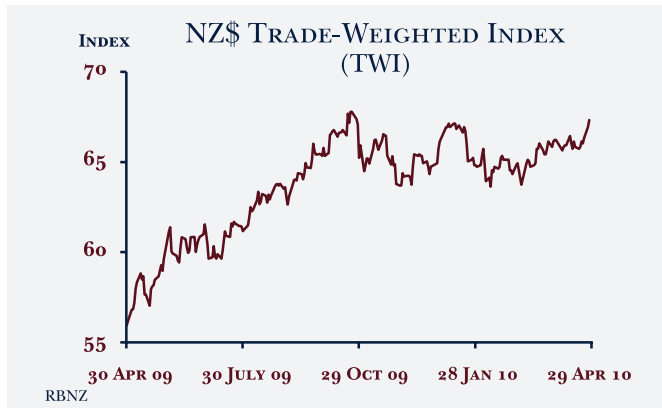


recovering from a very low base. Future expectations and some business confidence surveys show improvements, but the availability of credit and exchange rate volatility see little likelihood for longer-term sustained improvement in manufacturing's contribution to NZ Inc.

Monetary conditions remain unchanged

Since the March issue of BERL Forecasts, the 90-day rate has fluctuated within a range of 2.61% to 2.73%, with an average 2.67%. The 10-year bond rate at 5.94% is slightly below the average for the period of 5.96%. All in all, there is little change of economic significance.

Retail lending rates are similarly stable as shown by Reserve Bank figures for March but there is a rising trend in the average six-month term deposit rate which has risen steadily since its low point of 3.62% in March 2009 to 4.62% in March 2010, reflecting increased competition for domestic funding in light of continuing tight conditions abroad.



The TWI has also been relatively stable within a range of 65.3 to 66.1, but has appreciated since last week's OCR announcement to reach 67.5. However, some of this latest appreciation may well be being caught up in the turmoil as global markets digest the news of the bailout package for Greece.

The release on 29 March of the Preliminary Concluding Statement of the latest IMF mission disturbed markets briefly with its estimate that the NZ\$ was over-valued by 10% to 25%. Against all currencies there was an immediate decline of about 0.5% in the kiwi, but within a day the decline had been unwound.

BERL welcomes this confirmation of our view that the dollar is over-valued and agrees also with the mission's view that our overseas gross debt (borrowing) at 130% of GDP and an average current account deficit over recent years of 5% of GDP – creates risks to our financial sector. In this situation it recommends the government, with its lower risk premium, to stand ready to finance more of its own deficit from foreign sources, thereby reducing pressure on the financial sector.

The mission gives support to our freely floating exchange rate saying: "it has served New Zealand well in the recent turbulence". But that is not to say it would oppose a managed float as indicated, for example, by its praise of the Singaporean system in its latest report on the Singapore economy:

"Singapore's exchange rate regime, *which has helped achieve a track record of low inflation with prolonged economic growth*, continues to serve the country well" (our italics).

Our italicized bold is what we, ourselves, particularly like about the Singaporean regime. Not only does its managed float reduce volatility, but, by preventing excessive capital inflows, it prevents an excessive credit base and credit expansion, a major contributor to inflation; and does so without sacrifice to growth.

Notwithstanding the mission's support for the Singaporean system, it was critical of the actual rate, noting that on Fund models, the Singaporean dollar (as at May, 2009) was undervalued by about 5% on the Real Effective Exchange Rate basis (REER). The mission suggested that the authorities should allow some appreciation as world conditions improved. In the event, according to Bank of International Settlements data, the Singaporean REER has appreciated by about 1.5% as at March this year whereas the NZ\$ did so by about 9.5%. A further increase of 1.5% in the nominal rate followed the announcement of a rise in the permitted Singaporean range of the float so the REER has also probably now increased to about 3%.

This is an indication of Singapore's willingness to conform and ability to manage its rate as required.

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