



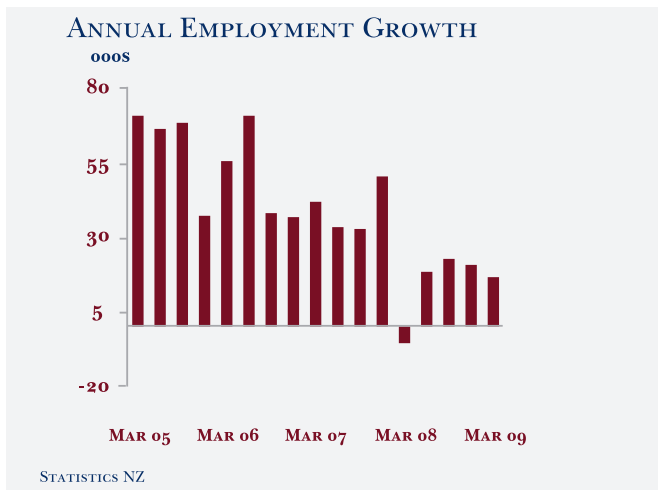
# BERL Monthly Monitor

## MAY 2009

### Obscured by obsession with the U-word

The actual state of the labour market and the economy has been obscured by many commentators' obsession with the U-word – unemployment.

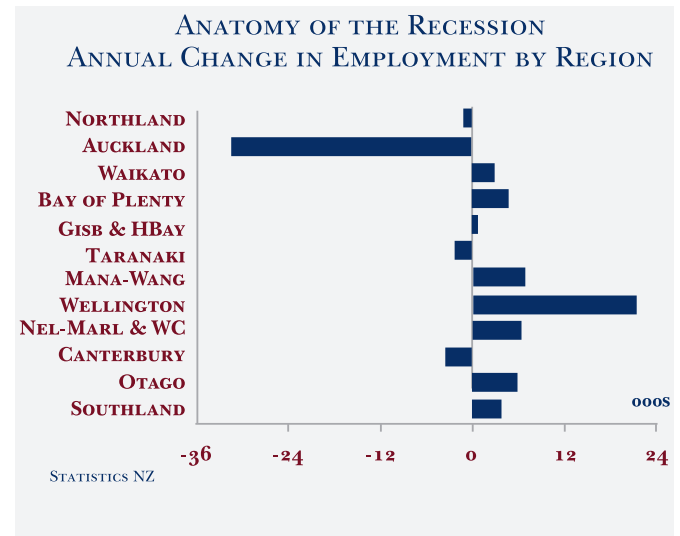
When the Household Labour Force Survey (HLFS) for the March 2009 quarter was published, many commentators trumpeted the increase in unemployment to 5% of the labour force. Some went so far as to opine that it was not as high as expected, and almost implied regret that unemployment is now unlikely to reach 10% next year.



That reporting prompts another U-word – unprofessional. A quick look at the neighbouring column of data on the HLFS which is employment – surely the main measure of the health of the labour market and the economy – would have provided a more informative assessment. Total employment in March 2009 was 2,173,500, which was 16,600 more than in March 2008. Now, 16,600 is not quite as many as the increase in people available for work, thus the number unemployed increased. However, these figures do not indicate a rapid drop into a black hole. Annual employment increases have been steadily declining since the increase by 38,000 two-and-a-half years ago, and over the last year have averaged 19,400. The 16,600 is just slightly less.

A little more investigation would have revealed two more startlingly informative snippets. The first is that most regions experienced an increase in employment in the last year. Auckland was the striking exception. Clearly, this is further evidence of the existence of two economies: boom-bust Auckland and steady-as-she-goes rest. In particular, the number employed in Auckland fell by more than 30,000 people over the year to March. This means that outside

of Auckland the number of people employed increased by over 47,000 over this same period. And that is a large number relative to New Zealand's labour force. It is way above the natural increase plus net inward migration. Look for some more internal migration out of the Super City!



Another snippet is that in the finer detail the job losses are mainly contained in some manufacturing previously damaged by the monetary fluctuations (wood-based, machinery etc) and the finance sector that caused it. There is already growth in food processing and manufacturing; in construction and even in the trades. There is strong growth in business services, presumably to prevent damage from the international 'flu, and preparing for a recovery. There is also growth in employment in education, which is hopefully being targeted at upgrading skills for an early recovery.

Some of the other social and personal services are also growing to carry communities and consumers along with the turbulent times.

What about employment in government administration? Here, the answer is zero-point-zero change. The March HLFS must have been before the effects of the activities of the mini Razor Gang. We hope it stays a Razor and doesn't become a Hatchet. Otherwise the Government could undo the good work of the rest of the economy and generate a deeper recession. Such a ruthless approach, were it to eventuate, would indeed be repeating the mistakes of the early 1990s.

## Quote of the Month

*“New Zealand is paradoxically at the forefront of the OECD in adopting policies in many areas that have been shown to lead to high per capita income, and yet it still ranks toward the bottom end of the OECD’s productivity league. .... But, the root of the problem is a structural deficiency in the capacity to produce tradable goods and services.”*

OECD Economic Survey of New Zealand, 2009

### Translation:

We’ve done what we’ve been told to do by putting in place policies that have worked elsewhere, but that hasn’t solved our productivity problems. And, “paradoxically” is probably code for: we really don’t know why.

Let us shed some light on this mystery. For starters, perhaps the policies that have worked elsewhere weren’t appropriate for a small, open economy with a large primary base persistently facing trade barriers? Next, might the “structural deficiency” have something to do with the lack of investment in the export sector? And, in turn, we can’t help wondering whether the lack of investment in the export sector has something to do with inappropriate interest rate and exchange rate settings? But, given we are at the forefront of the OECD in adopting the ‘right’ policies, we will have to remain paradoxically mystified.

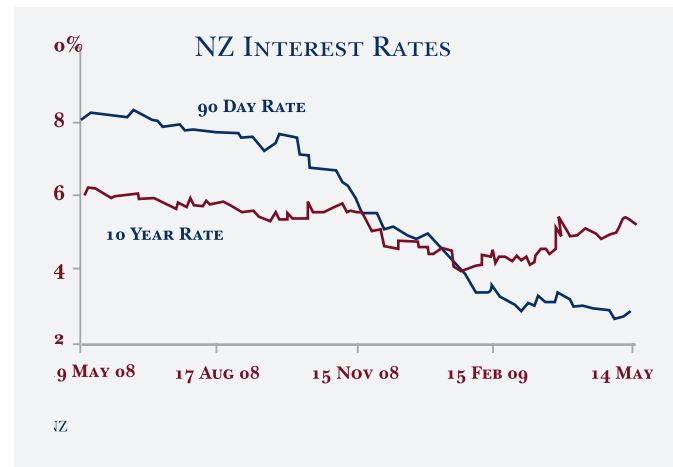
## Financial stability remains elusive

In its just-released six-monthly Financial Stability Report, the Reserve Bank (RB) provides a comprehensive review of the New Zealand financial system and the problems besetting it from the global credit crisis. The picture emerging from the analysis confirms BERL’s concerns that the currently tight credit situation is unlikely to improve in the near future. In particular, it is likely that foreign funding of New Zealand credit expansion will remain scarce and expensive.

Another problem is the likely further decline in asset prices exacerbating the situation as further damage is done to financial sector balance sheets. While the RB is confident New Zealand will be less badly affected than most economies, it does not under-estimate the likelihood of significant further contraction before full recovery is achieved.

It may be for this reason that the RB not only reduced its OCR by 50 points to 2.50% at its review on April 30, but more importantly, it indicated a virtual ceiling at or below this level until the latter part of 2010. This action removed an element of upside risk of the RB returning to an inflation-fighting stance. This, in turn, should eventually have a downward influence on the TWI. However, the response was a gradual strengthening of the NZ\$ to 59 on the TWI and 61 US cents, but as we go to press it has

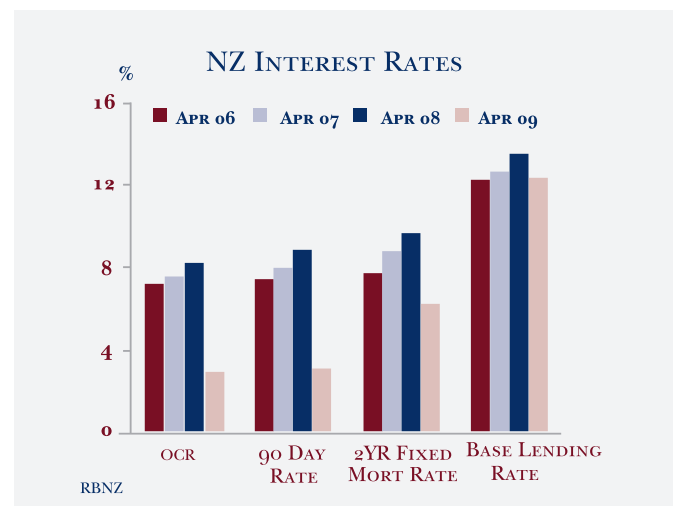
eased back to 57 on the TWI and about 59 US cents. Clearly, the all-knowing markets are having difficulty receiving the right message.



The main unknown in this situation now is the Budget on May 28. The Budget is expected to be fairly conservative, and as such likely to be welcomed in overseas financial circles, thereby ensuring continued availability of foreign funding for the banks. On the other hand, too tight a budget would lead to further contraction of the economy with consequential asset price declines and increases in debt default at a later date. Without doubt, it will be difficult to get the balance just right.

As to interest rates, the 90-day rate declined sharply to the 2.8% level but is now at 2.9%, apparently uncertain whether the next Statement on 11 June will contain a further OCR cut or not.

As the chart shows though, lower OCR and lower wholesale rates have only partially been passed on to those at the retail level. As widely reported, floating mortgage rates have declined slightly, but they remain on average close to 6.5%. Short-term fixed rates have fallen further, and are now at historically low levels. As is to be expected in a risk averse climate, longer-term fixed rates are now noticeably higher than floating rates. This is likely to remain the case for a while, with the primary issue being whether floating rates do actually heed the RB’s calls and decline further.



Of arguably more importance are the interest rates faced by small businesses. The relevant base lending rate has remained stuck in double-digits. While admittedly riskier lending, the growing premium being imposed on small businesses reinforces just how uninterested most banks are in participating in New Zealand's small business sector.

## Myths of our time

### Myth #1 – the \$50bn recession

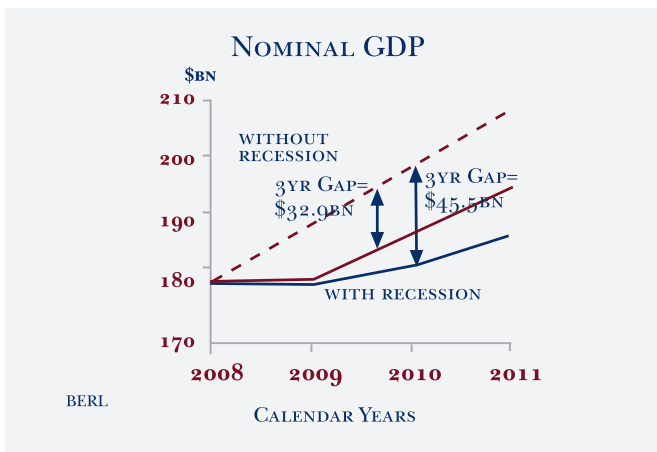
*To put the recession into context, we now expect the New Zealand economy to permanently lose about \$50 billion of output over the three years to 2012, compared with what would have happened without the recession.*

Nominal GDP in 2008 totalled \$179.8bn. Assume a potential real GDP growth rate of 3%pa and inflation at 2%pa. This would have resulted in GDP in the following three years of \$188.9bn, \$198.5bn and \$208.5bn. But latest Consensus Forecasts for New Zealand for 2009 and 2010 expect real growth of -1.7% and +2.0%, with inflation also expected at 2%pa. And conservatively adding another 2% real growth for 2011 yields a 3-year track of nominal GDP of \$180.3bn, \$187.6bn and \$195.2bn.

Quick subtraction suggests the recession causes a loss in nominal GDP totalling \$32.9bn over the three years.

Incorporating a much gloomier forecast for real growth of -1.7%, 0% and 1% and lower inflation of 1.7%pa, pushes the recession cost to \$45.5bn.

But, don't forget these calculations depend on the rather tenuous assumption that without the recession the economy would have immediately recovered from the anaemic 0.3% growth in 2008 to its growth potential of 3%pa in 2009, 2010 and 2011. A rather more defensible assumption for the non-recession growth path of the economy would lead to a much smaller 'hole' caused by the recession.



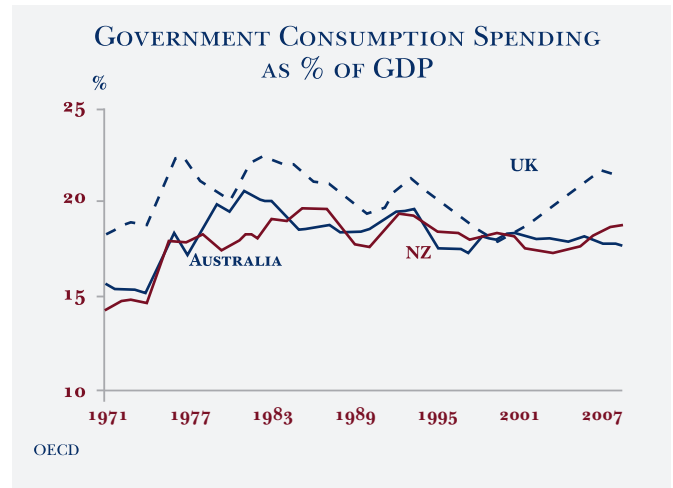
Yes, the recession is bad. But we really can't understand why some are proclaiming that the recession is worse than it actually appears.

### Myth #2 – the growing size of government

*The expansion of the number of bureaucrats in Wellington has resulted in a disproportionate growth in the size of government.*

This chart is derived from the OECD database. In 2007 government consumption spending (i.e. the Government's claim on the productive resources of the country) was 18.8% of total GDP, compared to Australia's 17.7%, Canada's 19.3%, the United States' 16.1%, the Euro area's 20.0% and the United Kingdom's 21.2%. Furthermore, the average for the 30 years to 2007 was 18.5%.

But, let's not spoil a good story with numbers based on fact.



### Myth #3 – the invaluable stabilisation role of the floating exchange rate

*The floating exchange rate is an invaluable automatic stabiliser for the New Zealand economy. It helps the economy slow down when positive external shocks means we might grow too fast and, gives economic activity a boost when faced with negative external shocks.*

The problem with this version of the mechanism is that it places the burden of most of the adjustment due to shocks onto the export sector. That is, when global demand for our goods and services is buoyant, the export sector is stifled by a rising exchange rate. Meanwhile, the domestic consumer enjoys cheaper imports (one of the fruits of a rising exchange rate), despite the brakes going on export earnings. In contrast, when global demand is subdued, the export sector is expected to rise up off its knees and lead a recovery with the help of a falling exchange rate.

Perhaps it might be better for the domestic sector to shoulder the adjustment burden, and leave the export sector to earn NZ Inc. an income. Just a thought.

### Myth #4 – the NZ economy is well-placed to withstand the impact of the global slowdown

*At \$168bn and growing, NZ's net debt stands at 93% of our annual GDP income.*

Earlier advice had been that this debt should not concern us. Firstly, because it was predominantly private debt and so was the result of the rational decisions of individuals who were fully entitled to make their own mistakes. Secondly, the rest of the world was clearly willing to lend to us. Further, the rest of the world was unlikely to say no to good old, respectable and stable NZ, given that we were so eagerly at the forefront of the OECD in adopting the

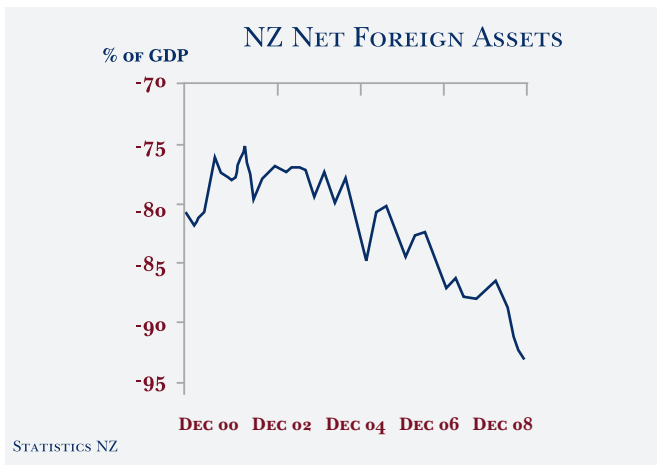


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correct policies. Of course, now the rest of the world is not so keen to lend to anybody, let alone little old NZ.

And then there is the fact that NZ went into a recession in early 2008 as a result of four years of monetary policy tightening to rein in a house-price-fuelled spending splurge. Of course, our timing was impeccable as we succeeded in being in a recession just as the world's financial systems imploded.

Sound well-placed to you?



### Food price inflation on way down (slowly)

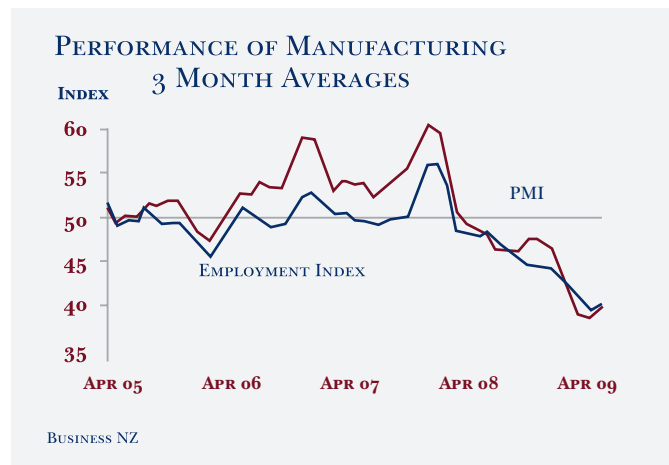
Food prices dropped in April by 0.6% on the previous month. This followed average food price rises being recorded in each of the previous three months. On the year however, prices are still up by 7.6%. Despite not wanting to sound like a broken record, we must note that annual food price inflation is unlikely to turn negative until at least September. This will be when the dreaded 2.8% monthly increase of August 2008 falls out of the calculations.

Prices in April were down on the month across all groups except for restaurant meals and ready-to-eat foods, which were up by 0.4%. Fruit and vegetable prices were down 2.0% and non-alcoholic beverages prices were down 0.9%. Grocery food prices fell for the second month in a row (by 0.4%) after 21 months of increases. Fruit and vegetable prices were well down. Kiwifruit prices were down almost 55%, carrots were over 13% cheaper, broccoli prices down 17% and lettuce prices down by close to 7%.

On the year, all sub-groups recorded price increases. Grocery food prices were up 6.7%. Meat, poultry and fish prices were up 11.5%, while fruit and vegetable prices were up 9.9%. Looking at individual items, the largest price increases on the year have been in the ready-to-eat-foods category (up 5.3%), bread (up 12.8%), and soft-drinks (up 7.2%). But pity should be reserved for the carnivores. Bacon is almost 20% dearer than a year ago; beef prices are up 12.5% with fresh chicken prices up 11.9%.

### Manufacturing sector – a faint pulse has been detected

Down, but not yet out, is an apt description of the state of New Zealand's manufacturing sector. Business New Zealand's Performance of Manufacturing Index (PMI) suggests April wasn't as bad as preceding months. The overall index now stands at 40.5 compared to 36.9 in February. As this remains well below the benchmark 50 level, this indicates activity in manufacturing is still contracting. However, the average of the latest three months is 39.7, above the 38.8 average for the three months to February. In addition, the employment index has also began snaking upwards.



Notably, the regional composition of the PMI reinforces the HLFs employment numbers. In particular, the three-month average for the Northern region PMI is 37, while the other three regions register above 40 figures. So, despite adverse conditions, it seems premature to dust off the obituary column for the manufacturing sector yet. Needless to say, the next few months will remain challenging for this sector.

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