



BERL Monthly Monitor

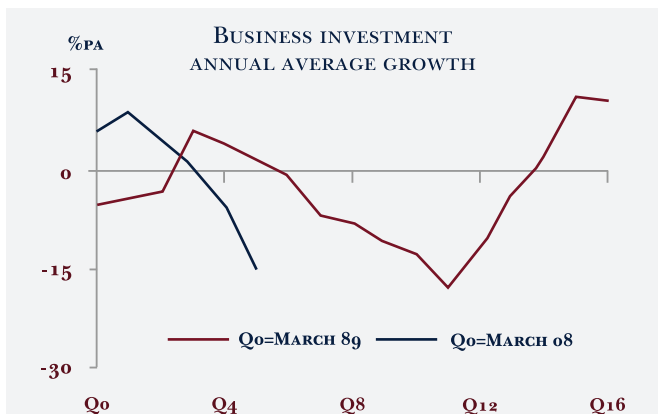
October 2009

GDP numbers allay a few concerns

While last month's release of the GDP numbers for the June quarter signalled the 'official' end of the recession, the developing composition of economic activity in the 'recovery' phase remains one of concern. Our recent website commentary summarises some of the key issues, which should at least temper the end-of-recession celebrations. In particular:

- Manufacturing GDP (including primary product processing activities) declined for the fourth consecutive quarter – by a further 1.5% in the June quarter. The manufacturing sector's average compound rate of growth over the past seven years has been 0.3%pa.
- Business investment declined for the fourth consecutive quarter – by a further 4.3% in the June quarter. Over the year to June, business investment has totalled 15% below that of the previous year.
- The year to June saw total export volumes total 31.1% of total GDP volumes compared to 30.4% a decade ago. In contrast the ratio of import volumes to total GDP has reached 34.5%, rising from 29.7% a decade ago.
- The \$27m (or 0.1%) increase in seasonally-adjusted GDP measured in 1995/96 prices was made up of:
 - i) a \$17m decrease in total GDP across all the constituent industries
 - ii) a \$28m increase in total GDP unallocated to any industry
 - iii) a \$16m increase in the statistical discrepancy.

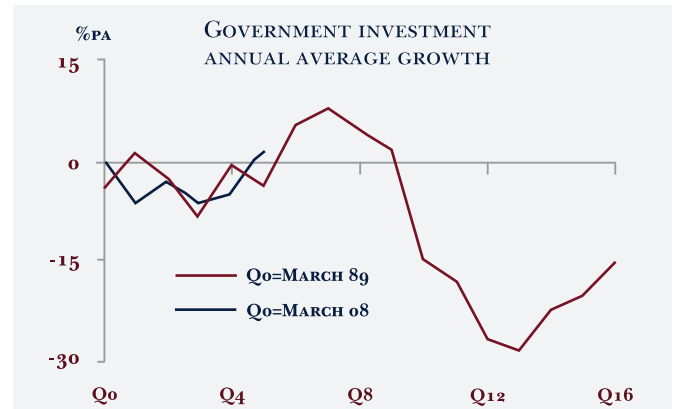
Of most concern, arguably, is the decline in business investment. If productivity is the true buzzword of the day (and there are good reasons it should be), then this drying up of business investment expenditure should be setting off alarm bells. Agreed, the sources of productivity improvements are not easy to identify. But long-term productivity improvements are unlikely to eventuate in an environment where business investment spending, and associated plans, remains fragile and fickle.



Indeed, the latest business investment numbers show an alarming similarity to those of the recession that spanned the late-1980s and early-1990s. As illustrated, business investment in the earlier recession also dived by more than 15%, but at a later stage of the recession. The fact that business investment turned down earlier during this recession is likely due to the availability of credit and cash flow considerations over the past year.

In this context government investment becomes even more important. That is, government investment is required not only to maintain demand and activity levels across the economy, but also to set the foundations for productivity improvements over the longer term. Again, the comparison with the earlier recession is informative. In the early-1990s, government investment slumped by close to 30%.

Remembering that government investment includes both the central and local government sectors, continuing calls by some for local government to rein in its activities will no doubt result in serious consequences. A repeat of the earlier government investment picture will no doubt see the productivity debate also continuing in 20 years time, with little likelihood of any resolution.



Migration driving fundamentals

Watch our migration forecasts when we update them for the December *BERL Forecasts*. We are likely to be forecasting a net migrant inflow of 20,000 people for the 2009 calendar year, up from the 3,814 inflow in the 2008 calendar year.

The average net inflow for the last 23 years has been 6,000 people per annum. A forecast net inflow of 20,000 is therefore 14,000 people more than the average. In the past when net migration has been running high, economic growth has also been strong. These periods have included the mid-1960s and the mid-1970s. Following the disruption and restructuring of the mid-1980s, the mid-1990s saw the net inflow climb to the 20,000 to 30,000 per annum range. From 2001 to 2004 an annual net inflow of 20,000 to 40,000+ was experienced.

The mechanism for migration driving economic growth is fairly obvious. Of the 20,000 net inflow in 2009, about 16,000 people are expected to be over 15 years old and the average

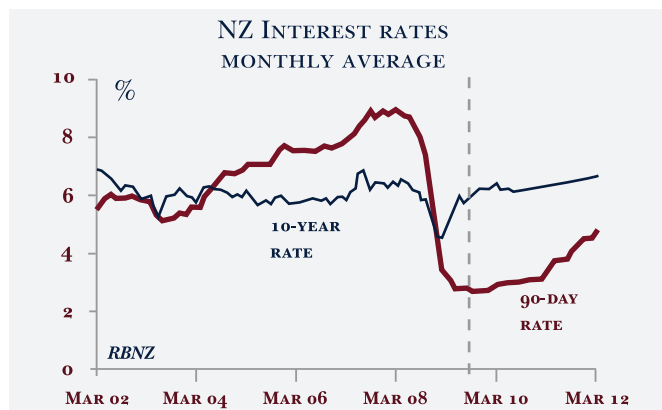
labour force participation rate of migrants is usually greater than of the whole population. If the labour force participation rate was therefore 80%, compared with the population average of about 70%, this would mean migrants would generate an additional 12,800 wage packets. Given the reality of young peoples' access to ATMs and their spending behaviour, these 12,800 wage packets will probably support an additional 20,000 consumers!! The net migrant increase is likely to create something like 13,000 additional households each requiring a house or apartment, a set of whiteware, TV and furniture, floor coverings, a mortgage, credit card etc etc.

The real requirement for the economy to benefit from this is for the productive capacity to also increase. This is required so that the increased demand, especially for dwellings, does not just drive increased house prices. If interest rates are raised in 2010 and attract strong inward money flows, this will further fuel house price inflation unless the building industry capacity can cope with the increase. Given other demands for more houses as replacements or for increased household formation, it would seem the demand for new dwellings going forward should lift back to around 20,000 per annum.

Increases in net inward migration, even if they are largely driven by a reduction in the number of Kiwis leaving home, are a sound basis for economy expansion. But, can this be sustained through to the mid-2010s and beyond?

Monetary conditions defy fundamentals

Wholesale interest rates have fluctuated during the past month around an average of 2.77% for the 90-day rate and 5.61% for the 10-year bond, both with little discernible trend. The Trade-Weighted Index (TWI), on the other hand, has continued on the upward trend which began at the 51 mark in early March, rose to 63.8 in mid-September and is now at 66.5, i.e. a total appreciation of the NZ\$ of about 30%.



The main contributor has of course been the depreciation of the US\$ over the same period, about 30% against its own TWI and 50% against the NZ\$. The strength of the NZ\$ is evident in the cross-rates for the 14 currencies in the latest Reserve Bank of New Zealand (RBNZ) statistics, which shows the NZ\$ appreciating against all currencies during this period. In particular, contrary to all the fundamentals, the NZ\$ appreciated 27% against the Euro, increasingly the main competitor to the US\$ as a reserve currency. Similarly, against the fundamentals, the Kiwi has even strengthened against the Aussie by 3%.

The reasons for this strength are: firstly, government policy, notably presentations by the Prime Minister and the Minister of Finance in world financial markets; secondly, RBNZ policy of limited intervention in the forex market; and thirdly, a general perception that the Australia/New Zealand banking system is particularly "sound". The latest move confirming this last

perception is the RBNZ's announcement that it will be removing some of the emergency liquidity facilities put in place in 2008.

Much as these perceptions help to maintain the financial status quo, the problem is that the over-valued Kiwi is the reverse of what the economic fundamentals require, namely a stable TWI in the 50-55 range. This is the necessary prerequisite for the restructuring towards tradeables our authorities so frequently call for.

We believe economic fundamentals will eventually prevail over these perceptions, at which point the NZ\$ will depreciate to the level it should always have been. This is the good news. But it could possibly leave our banking system with a funding problem, which could lead to reduced lending and maybe severely damaged balance sheets, which is the bad news. The longer it is delayed the greater the pain of the adjustment.

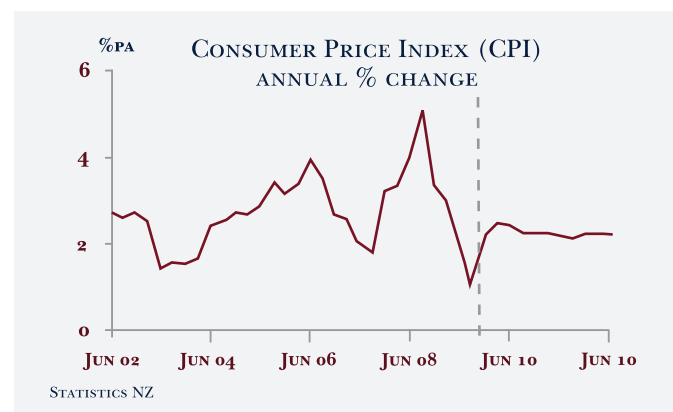
To some extent this is already the situation. Latest lending figures show a continuation of the extremely tight credit availability that has occurred throughout this year. Agriculture is the only sector with positive growth, namely an annualised monthly rate of 8% in August compared with twice that rate a year earlier, while all other sectors are negative with lending growth overall barely positive at 1%.

Latest retail interest rates also show little change. The average base lending rate at the end of September was 10.03% compared with 10.07% the month before; there was a reduction in the first mortgage rate for housing to 6.16% from 6.42%; and a rise from 4.10% to 4.24% in the six months deposit rate.

Looking to the immediate future, the next review of the OCR is on October 29 and some sections of the market are expecting a 25 points rise to 2.75% in view of the latest CPI quarterly increase of 1.3% and other signs of a recovering economy. Our view is that the RBNZ will do its best to hold off on any increase at this time. But the odds are fairly even, especially in view of the Reserve Bank of Australia's increase this month.

Mixed messages from CPI figures

The CPI rose 1.7% in the year to September 2009 quarter, down from the 1.9% and the 3.0% in the two previous quarter years. This was the lowest annual increase since the year to the March 2004 quarter. This record low annual increase masks the fact that, on the quarter, prices rose 1.3% following smaller increases of 0.6% and 0.3% in the two previous quarters and a fall of 0.5% in the December quarter. The reason it was a record low was more on account of the 1.5% increase in the quarter to September 2008 falling out of the annual calculation.



In reality, this quarterly increase was well above what was forecast, and would immediately suggest that there are indeed pressures on prices. However, when looking at what went up in the quarter, you could argue that the increase in prices it isn't being driven by a recovering market. Apart from international

air transport (which was up 11%) the major increases were from local authority rates and payments (up 5.6%), and vehicle relicensing fees (up 16.2%).

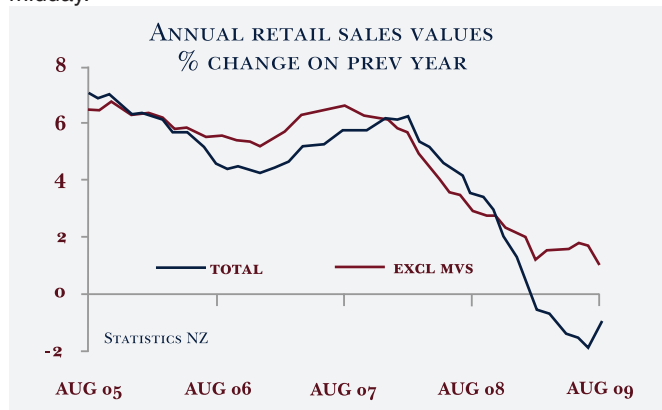
Transport prices increased 3.1%, food prices were up 1.7%, and housing and household utilities were up 0.7%. These were driven by higher international air transport and vehicle relicensing fees, higher vegetable prices, and higher local authority rates and payments. On the year, the 1.7% increase was driven by food prices (up 5.4%) and housing and household utilities (up 2.1%). Interestingly, second-hand car prices were up 12.9% on the year.

Keeping prices down was the lower price for petrol (down 19%) and diesel (down 38.8%), and overseas package holidays (down 11.9%). Even though international air transport prices were up 11% on the quarter, they were still down 15.1% on the year.

Looking forward, annual CPI should return to 2% in the December 2009 quarter and will then gravitate towards the higher end of the RBNZ's 1-3% target band, by which time the RBNZ will have the OCR on an upward trend.

Retail sales begin to thaw

The latest retail trade stats are somewhat of a warm relief to the recent chilly weather. Seasonally adjusted sales rose by 1.1% in the last month. But the cool conditions may have contributed to the pick-up in retail sales. Clothing and soft goods sales in August had the largest increase (\$14m, 6.6%) across the 24 industries that StatsNZ monitors. These statistics are being taken as another important indicator by the markets that the worst of the recession in New Zealand is over. The impact on the currency was immediate. Following StatsNZ's 10:45am release, the Trade-Weighted Index (TWI) immediately rose against all of our major trading partners' currencies. It surged up, climbing by 0.5 points to 66.54 by midday.



At an industry level, the August statistics show slight falls in supermarket and grocery stores, other food retailing, and appliance and recreational goods retailing. However, given the size of the changes were between -0.2% and -1.5%, it is likely that these contractions were substantially driven by lower retail inflation (or even deflation) rather than dramatic cut backs in sales volumes. We will have to wait for the quarterly statistics to pull apart the influence of price changes from real volume changes though.

There remain seemingly conflicting messages in the statistics. While the seasonally adjusted figures look positive, actual sales fell by 2.1% in the month of August and they were 1% lower than the same month a year ago. The negative aspect is primarily driven by the automotive sector. Core retail sales were \$94m higher in August 2009 than they were in 2008, while automotive sales were \$151m lower.

In addition, the overall level of growth remains modest. The 1.1% monthly increase in seasonally adjusted sales is mild relative to the medium-term average. But again, much of this was due to weakness in the automotive sector.

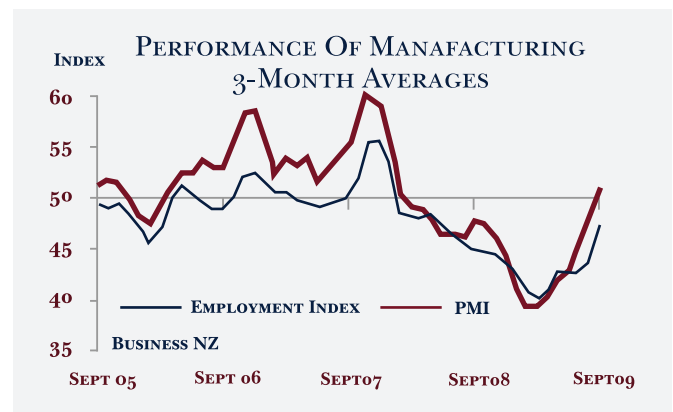
This suggests while perhaps we shouldn't be negative, neither should we overstate the growth in the retail sector nor neglect the underlying patterns in the core and automotive sub-sectors. The picture of a fragile recovery continues, and much of this picture seems to be coloured with sentiment. At the moment, it is a rosy, if somewhat chilblained, pink. But the current positive net migration will help to stimulate demand and add some heat to the retail sales sector.

Manufacturing growing (just)

The Bank of New Zealand – Business New Zealand Performance of Manufacturing Index (PMI) stood at 51.7 in September, up 3.0 points from August (48.7) and 2.0 points from July (49.7). This result is an improvement year-on-year, and indicates that manufacturing activity in New Zealand is beginning to show signs of expansion for the first time since April 2008. A PMI reading above 50 indicates manufacturing activity is expanding, while a result below 50 indicates contraction.

Four of the five seasonally adjusted sub-indexes measured recorded an expansion, with new orders (56.3), employment (51.2), deliveries (51.1), and production (51.6) recording values above 50. Four of the five seasonally adjusted sub-indexes measured also recorded an improvement on the previous month. Finished stock recorded a result poorer than the previous month, down 4.3 points from the 48.7 recorded in August, and was also the only sub-index to continuing showing signs of decline.

The new orders sub-index has been recording slight improvements since June, but this month was the best result to date, up 6.0 points from August. The second best result month-on-month was the employment sub-index which improved 4.3 points from August. This is the highest value recorded for the seasonally adjusted employment sub-index since November 2007, when it stood at 57.2. As indicated in the figure below, this index has been below 50 for some time and while it is positive to see an improvement this month, the three-monthly average remains below 50 and may continue to stay there for some time.



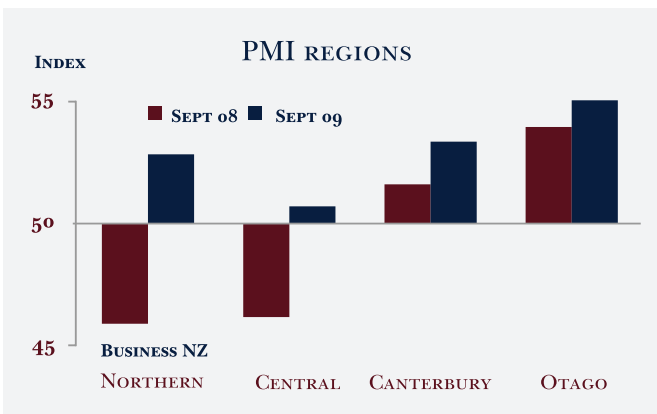
Looking at manufacturing activity by industry sub-group it can be observed that the food, beverage and tobacco manufacturing sector continues to do well. Between July and August manufacturing activity in this sector rose 4.5 points to 56.3, while between August and September manufacturing activity expanded by 3.8 points to 60.1.

The petroleum, coal, chemical and associated products sector experienced a sharp fall to 46.8 in August, but recovered in September gaining 8.7 points.



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The three-monthly average for the PMI improved in September to sit at 50.9, up from the 48.0 recorded in July. All three quarterly average indicators have improved, with employment showing the strongest result, up 4.0 points. Over the last three months, production has averaged 50.9, an improvement on the previous quarters and the best result seen since January 2008.



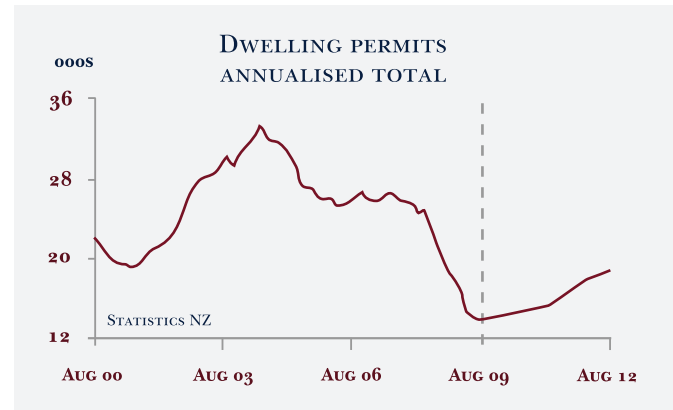
Turning to the regions, the unadjusted activity for September is quite a different picture than that seen in August with all regions recording an expansion in manufacturing activity this month. As shown in the figure, a comparison of manufacturing activity in the regions year-on-year indicates improvements could be starting to slowly happen. Last month the Central and Canterbury regions recorded an expansion in manufacturing activity while activity in the Northern and Otago regions contracted. This month, manufacturing activity in the Central (50.7) and Canterbury (53.3) regions remained above 50 but contracted by 1.6 and 3.1 points respectively. Comparing month on month, the Otago region lead the way for the second month in a row with an improvement in manufacturing activity of 10.5 points. While the Northern region also improved, up 5.5 points respectively from August.

Building consent figures remain low but are improving

There were 1,195 building consents issued for new dwelling units in August. This is a slight decline from the number of consents issued in July 2009, and 133 units less than the number issued in August 2008.

The number of building consents issued, excluding apartments, was 1,165 units in August 2009, six units more than in July 2009 and 39 units less than in August 2008. The number of building consents issued for new apartments fell to 30 in August 2009, a far cry from the 124 units issued with consents in August 2008 and the 771 consents issued in April 2008. Further, this small

number also includes consents for alterations and additions to existing buildings.



Looking year on year, fewer new dwelling units were authorised in seven of the 16 regions. The regions with the largest decreases in the number of new dwellings authorised for August 2009 compared with August 2008 were Wellington, down 65 units to 108 units, and Auckland, down 60 units to 216 units.

During this period, Wellington City has seen the largest turnaround in new dwellings authorised. In August 2008, 123 new dwelling units were authorised in that month by Wellington City, in August 2009 this figure had dropped to 34 dwelling units. Building consents in many cities during this period have remained relatively stable or declined slightly. Hamilton City in contrast has grown from 20 dwelling units authorised in August 2008 to 79 dwelling units in August 2009.

Turning to monthly figures in the regions, the Canterbury region had the largest number of dwelling units authorised in August 2009, with 235 units. This was followed by the Auckland region with 216 units and the Waikato region with 200 units. In terms of the value of units authorised, the Auckland region continues to lead the way with \$72m, while the Canterbury region recorded \$63m.

Within the Canterbury region, Christchurch City had the highest number of new dwellings authorised in August 2009, at 100 units. However, this is below the figure seen in Christchurch City in August 2008, when 147 new dwelling units were authorised.

Waimakariri and Selwyn District have seen growth in the number of new dwelling units authorised. Moving from 30 to 51, and 35 to 50 dwelling units authorised respectively. In contrast, popular holiday areas such as Taupo, Central Otago, and Queenstown-Lakes have seen drops in the number of dwelling units of 13, 11, and 15 respectively.

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