EUROPEAN UNION

DELEGATION TO NEW ZEALAND

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Note to Mr Alan Seatter,
Director, DG Relex C

Subject: **New Zealand Quarterly Economic Situation Report, mid April 2010**

New Zealand's recession – triggered by a drought and exacerbated and extended by the global financial crisis – is now confirmed as over. Data from the December 2009 quarter showed a rebound in manufacturing as demand increased and companies restocked inventories run down by the recession. Residential construction has also seen a solid improvement with increasing demand. However, this has not yet translated into a reduction in unemployment.

Key figures from the December 2009 quarter:

- Economic activity increased 0.8% compared to the previous quarter's 0.3%.
- The Reserve Bank says the economy will grow 3% in 2010 and 3.5% in 2011;
- Unemployment reached 7.3%, the highest since June 1999;
- The seasonally adjusted current account deficit was NZ$3.1 billion this quarter.
- The Official Cash Rate (OCR) was unchanged at 2.5%.
- Exports in goods and services fell 0.9% while imports were up 6.0%.

NZ Budget day will be 20 May. Highlights are expected to include a rise in the universal Goods and Services Tax (similar to the VAT) with a commensurate decrease in personal tax rates.

George Cunningham
Chargé d'Affaires a.i.

PO Box 5106, Wellington 6145 New Zealand
Tel: +64 4 472 9145 - Fax: +64 4 472 9147
Email : delegation-new-zealand@ec.europa.eu Website : http://www.delaus.ec.europa.eu/newzealand

Overall economic conditions

The December 2009 quarter showed 0.8% of growth, the strongest in almost two years with a 0.5% rise over the previous quarter. Private consumption, in particular manufacturing and residential investment, grew strongly as a result of low interest rates. Indeed, the rebound in manufacturing accounted for about 60% of December's quarterly growth, reflecting increased global demand for commodities, including food, wood products, oil and metal manufacturing. There were also initial signs of increasing business investment and a modest lift in household spending. However, the lift in manufacturing has not meant more jobs or higher wages so far. Recent indicators pointed to a pullback in consumer spending and the housing market had been weaker because of expected property tax changes, due to be announced in the May 2010 Budget. As might be expected from NZ's experience of a relatively shallow recession, the Reserve Bank estimates that the NZ economy grew at a stronger pace in the December 2009 and March 2010 quarters than the prior two quarters.

In early March, RBNZ Governor Alan Bollard said that overall the NZ economy is recovering broadly as anticipated and growth is predicted to pick-up further through 2010. The Reserve Bank has forecast 3% economic growth in 2010 and 3.5% in 2011. However, the growth is forecast to be more subdued compared to previous recoveries.

The IMF completed its annual check-up of the NZ economy in early April. On its view, NZ's key vulnerabilities continue to be levels of household and external debt, both of which are high by advanced country standards. The IMF supports the tax reform announced by the NZ Government to shift more of the tax burden from income to consumption. However, the IMF team told the NZ Government to get tougher on spending by better targeting broad based schemes like Working for Families, student loans and free GDP visits. PM Key rejected that call, saying that as his National party had campaigned to maintain those entitlements, "It's not my intention to break those promises".

Monetary Policy

On 11 March 2010, the RBNZ left the **Official Cash Rate** steady at a record low 2.5%. This was the seventh consecutive review of the OCR, in which it has remained unchanged since June 2009. Bank economists continue to expect the RBNZ to lift the OCR by 25 basis points to 2.75 % in June 2010.

The **Consumers Price Index** (CPI) fell 0.2% in the December 2009 quarter from the September 2009 quarter. Food prices fell 2.4%, mainly due to lower vegetable prices. This was partially offset by transport prices, which rose 1.5% in this quarter with higher prices for international air transport and second-hand motor cars. Annual CPI inflation is currently at 2%, and is expected to track within the target range of between 1 and 3% over the medium term. In the short term, implementation of the amended Emissions Trading Scheme and increases in ACC (the state accident compensation scheme) charges will push CPI inflation toward the top of the target range.

Exchange rates at 14 April 2010

NZ$1	€0.5213	US$0.7096

In this quarter, the NZ dollar appreciated against four (US, UK, Euro and Japan) of its five major trading partners' currencies. It dropped only against the Australian dollar (- 1.0%). The greatest appreciation was against the British pound (up 8.6%), followed by an 8.1% appreciation against the US dollar.

According to the exchange rates published by the RBNZ and on **the trade weighted index[1] (TWI)** basis, the NZ dollar rate has hardly moved since the Reserve Bank's December 2009 Statement. The TWI average in 2010 is estimated to be 62.7% compared with 61.6% in 2009.

Fiscal policy

NZ's **net debtor position** (liabilities exceeding assets) at 31 December 2009 was NZ$167.5 billion (90.3% of GDP), NZ$5.3 billion smaller than at 30 September 2009. This was the largest fall in the net debtor position since the series began in June 2000 and was mainly driven by valuation changes to assets and liabilities. Part of this activity was due to banks resetting their financial derivative contracts during the quarter.

General government final consumption expenditure increased 0.9% in the December 2009 quarter, and was up 1.4% for the year ended December 2009. Central government expenditure increased 0.7% in the December 2009 quarter, driven by education, public order and safety, as well as defence. Local government final consumption expenditure increased 2.5% in the December 2009 quarter.

Personal conditions

As reported by Statistics NZ, **household consumption expenditure**, which measures the volume of spending by NZ-resident households on goods and services, was up 0.8% in the December 2009 quarter. Also, household expenditure on durable goods increased 1.4% as did non-durable goods (up 1.3%) whereas both had declined in the September 2009 quarter. For the year ended December 2009, household consumption expenditure fell 0.6%. This driven by decreases in durable goods (down 3.1%) and non-durable goods (down 0.1%), partly offset by services (up 0.6%).

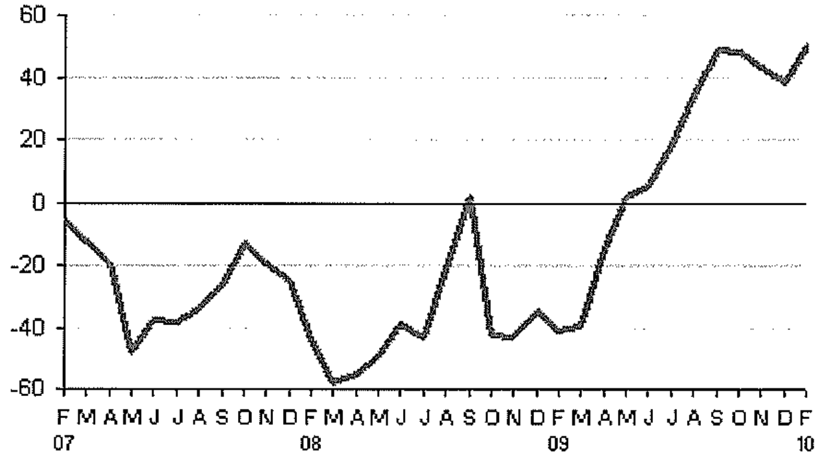
The **Consumer Confidence Index** moved modestly lower in the March 2010 quarter, but remains at a high level. The Index now stands at 114.7. An index number over 100 indicates there are more optimists than pessimists, while a number under 100 indicates the opposite. Consumer confidence peaked at a four-year high of 116.9 in December 2009, but has slipped back over the past three months. Consumers' optimism about the future has tempered, while their assessment of current conditions has improved slightly.

[1] The TWI is a measure of the value of the NZ dollar relative to the currencies of NZ's major trading partners.

Business conditions

Business confidence has hit a decade high. A net 50% of respondents expect better times ahead compared to 38.5% in January 2010. Confidence is strongest across the manufacturing, construction and service areas. The retailing sector recorded a fall in confidence (28.8%) down 14 points since December 2009.

BUSINESS CONFIDENCE INDEX



Percentage expecting improvement in general business conditions minus percentage expecting deterioration.

Source: NBNZ Business Outlook

Primary industries fell 1.3% in the December 2009 quarter, following a 3.0% increase in the September 2009 quarter. The fishing, forestry and mining industries (down 5.1%) were the main drivers of the decline. Agricultural activity increased 1.1% as a rise in milk production was partly offset by a decline in livestock production. However, mining activity was down 7.6%, but this was more a reflection of higher than usual exploration activity in the previous quarter. For the year ended December 2009, primary industry activity increased 1.2%.

Goods-producing industries increased 3.0% during the December 2009 quarter, which was mainly came about by a growth in manufacturing activity (up 4.5%). Electricity, gas, and water activity also rose (up 2.5%), while activity in the construction industry declined (down 0.6%). The 4.5% increase in manufacturing activity is the first quarterly increase since the December 2007 quarter. The main contributors to the rise was food, beverage, and tobacco manufacturing (up 5.4%), metal product manufacturing (up 8.1%), and petroleum, chemical, plastic, and rubber product manufacturing (up 6.1%).

Activity in the **services industries** increased 0.4% during the December 2009 quarter. The largest gains in services came from wholesale trade (up 2.7%), the first growth since the December 2007 quarter, in such areas as retail, accommodation, and restaurants, (up 1.7%) as well as transport and communication services (up 0.5%). Government administration and defence in both central and local government increased 1.0%. Lower activity in personal, health, and community services (down 1.1%) partly offset these increases in the December 2009 quarter. The decline in personal, health, and community services was due to health, and culture and recreation services. For the year ended December 2009, activity in the services industries increased 0.9%.

Gross fixed capital formation (GFCF) measures investment in fixed assets by households, business, and government. GFCF decreased 0.9% in the December 2009 quarter. This was largely the result of reduced investment in intangible assets (software and exploration), which dropped 25.8%. This significant decline followed a large rise in the September 2009 quarter where there was higher than usual exploration activity. Investment in capital equipment increased for plant, machinery, and equipment (up 4.1%), and transport equipment (up 7.0%). These increases are consistent with the growth in imports of these types of goods, and increased domestic production seen in the December 2009 quarter. For the year ending December 2009, GFKF was down 12.2%. The main contributors to this decline were investment in transport equipment (down 42.5%), plant, machinery, and equipment (down 16.8%), and residential building (down 16.8%).

Labour market

Employment fell by 2,000 (0.1%) during the December 2009 quarter. In the same period, **unemployment** rose 0.8% to reach 7.3%, the highest since the June 1999 quarter when it was also at 7.3%. This compares with an unemployment rate of 6.5% in the September 2009 quarter and 4.7% in the December 2008 quarter.

Consequently, the **Quarterly Employment Survey** results for the year to December 2009 show that the demand for labour has continued to decline. Full-time equivalent employees, filled jobs, and seasonally adjusted total paid hours have all decreased compared with the same period of the previous year. This is the fifth consecutive quarter decrease.

Annual wage growth (salary, wage and overtime) eased to 1.8% in the December 2009 quarter. This is the smallest growth rate since 2001 and reflects the weakening labour market over the past year, during which time unemployment rose strongly. In the year to September 2009, annual wage growth was 2.1% while a year ago, annual wage growth was increasing 3.5%.

International trade figures

Export volumes of goods and services fell 0.9% in December 2009 quarter, following a 0.2% increase in the previous quarter. The volume of goods exported decreased 0.3% in the December 2009 quarter. The largest declines in export volumes were for dairy products (down 7.1%), and agriculture and fishing primary products (down 5.0%). Partly offsetting these declines were increases in export volumes for meat products (up 12.4%), and other food, beverages, and tobacco (up 11.9%). Exports of services were down 0.3% in the December 2009 quarter.

Import volumes of goods and services were up 6.0% in the December 2009 quarter, following an increase of 1.5% in the September 2009 quarter. The volume of goods imported increased 7.6% in the December 2009 quarter, the largest rise since the March 2004 quarter. Imports increased across the board, predominantly in capital goods (up 11.5%), made up of machinery and plant, and transport and industrial equipment. Imports of passenger motor cars (up 32.2%) and intermediate goods (up 4.9%) also increased this quarter.

The **export price** index fell only 0.3% in the December 2009 quarter, a substantial improvement following falls of 5.4% in the September 2009 quarter and 11.9% in the June 2009 quarter. The latest quarterly fall in the total export price index was primarily driven by lower prices for meat and for fish. Higher prices for dairy products and fruit went some way to balancing overall quarterly fall. The appreciation of the NZ dollar had a downward influence on export prices in the latest quarter.

At the same time, the **import price** index fell 5.8% in the December 2009 quarter, following decreases of 3.9% and 2.8% in the September 2009 and June 2009 quarters, respectively. The decline in import prices is a result of the NZ dollar appreciation against all of its major trading partners' currencies.

The **merchandise terms of trade** rose 5.7% in the December 2009 quarter due to export prices (down 0.3%) falling less than import prices (down 5.8%). In the year to the December 2009 quarter, the merchandise terms of trade index fell 8.3%, following gains of 1.8% and 8.8% in the years to the December 2008 and 2007 quarters, respectively. The latest quarterly rise in the merchandise terms of trade means that in the December 2009 quarter, 5.7% more merchandise imports could be funded by a fixed quantity of merchandise exports than in the September 2009 quarter.

The **current account balance** switched to a deficit of NZ$3.1 billion for the December 2009 quarter from a surplus of NZ$39 million in the September 2009 quarter. This was attributed to greater profits made by foreign owned companies in NZ and a reversal of some tax provisions by big banks. The surplus in the previous quarter was the first since the December 1988 quarter. For the year ended December 2009, the current account deficit was NZ$5.5 billion (2.9% of GDP). This compares with a current account deficit of NZ$5.9 billion (3.2% of GDP) for the year ended September 2009 and NZ$16.0 billion (8.7% of GDP) for the year ended December 2008.

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