

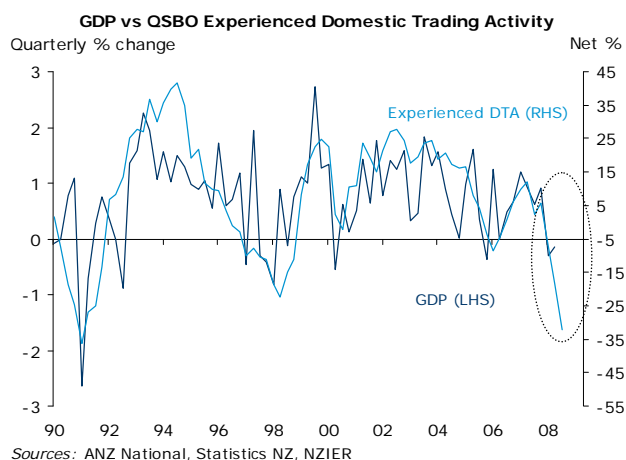
Quarterly Survey of Business Opinion: September 2008 quarter

Key points

- > **Headline confidence rebounds, but likely reflects a false dawn as responses would not have fully captured more recent events.**
- > **Capacity pressures eased across the board and demand slowed considerably.**
- > **Firms on a hiring and investment freeze as profits remain under pressure.**
- > **The RBNZ will see the easing in resource pressures as giving it more room to front-load the easing cycle.**
- > **We continue to look for a 50bp cut from the RBNZ on 23 October, but are starting to think about 75.**

Assessment

Today's QSBO confirms growth remains non-existent. While headline confidence recovered from last quarter's weakness, with a net 24 percent of firms expecting the general business situation to deteriorate, up from a net 54 percent in June, firms reported a further sharp drop in activity in the September quarter. A net 32 percent of firms reported their own activity decreased over the past three months. This is the weakest result since the March 1991 survey and points to a large contraction in Q3 GDP. We have been surprised with how muted the contraction in H1 growth has been, but today's data suggests the September quarter could be worse. Firms are slightly more optimistic about their own prospects over the next three months, with a net 13 percent expecting a decrease, but this remains well in negative territory and suggests subdued (if not negative) growth for the remainder of the year.



Some, but not all, of the recent global events would have been picked up. While most of the responses to the survey were received after the 50bp rate cut from the RBNZ in September and covered some of the global financial market

volatility, it would not have captured more recent events such as further turmoil in financial markets around the globe, confirmation the economy is in recession, and the lowering of Fonterra's 2008/09 payout forecast. In this sense, we suspect the survey likely overstates the rebound in headline confidence.

| | Headline business confidence | | Domestic trading activity – next 3 mths | | CUBO | Avg selling price – next 3 mths |
|----------------|------------------------------|------------|---|------------|---------------|---------------------------------|
| | actual | s.a. | actual | s.a. | | |
| Q3 2006 | -19 | -21 | 10 | 8 | 0.9230 | 28 |
| Q4 2006 | 3 | -9 | 15 | 13 | 0.9171 | 28 |
| Q1 2007 | -15 | -9 | 16 | 17 | 0.9182 | 40 |
| Q2 2007 | -37 | -28 | 9 | 13 | 0.9156 | 35 |
| Q3 2007 | -27 | -29 | 15 | 13 | 0.9134 | 34 |
| Q4 2007 | -26 | -39 | 14 | 12 | 0.9204 | 35 |
| Q1 2008 | -64 | -58 | -10 | -8 | 0.9262 | 45 |
| Q2 2008 | -64 | -54 | -23 | -18 | 0.9237 | 49 |
| Q3 2008 | -19 | -24 | -8 | -13 | 0.9079 | 28 |

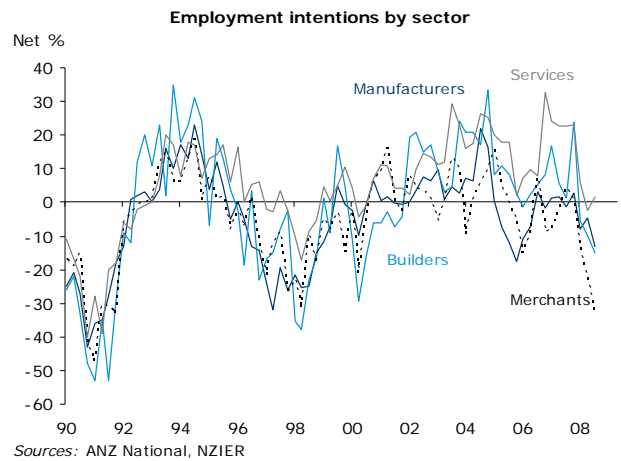
On a sectoral basis, demand is weak across the board. Like the economy-wide measure, headline confidence recovered across all sectors. However, output and new orders was weak in the September quarter, particularly for builders and merchants. The outlook for new orders remains negative for builders and merchants, but is flat for manufacturers. Interestingly, architects report an improvement in the outlook for work in their own office over the next 12 months, albeit off low bases. The largest increase in work came from the government sector, a clear sign that fiscal policy is set to be the sole driver of growth heading into 2009.

Not surprisingly, demand is the biggest constraint for firms. In the September quarter, 68 percent of firms identified that sales were the major limiting factor, while 27 percent pointed to supply-side factors (10 percent labour, 8 percent

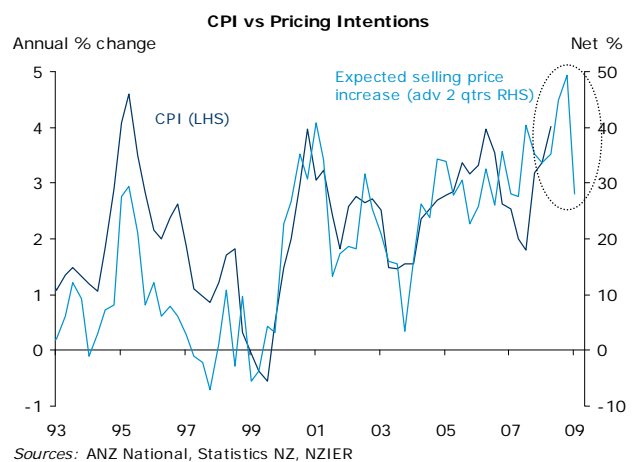
capacity, 7 percent finance and 2 percent materials). This compares with 59 percent stating sales as the major limiting factor in the June survey. We expect this theme to continue as the economy slows, but we will be closely watching those highlighting the availability of finance given the turn in the credit cycle.

This weak demand backdrop is resulting in easing resource pressure. Capacity utilisation eased to 90.8 percent in the September quarter from 92.4 percent in June. This is still elevated but is the lowest level since 2003 and the drop was recorded across both manufacturers (exporters and non-exporters) and builders. Firms are reporting less difficulty in finding both skilled and unskilled labour. A net 5 percent of firms stated that it is more difficult to find skilled staff, but this is down from a net 19 percent in June and is the lowest level since 1998. A net 16 percent of firms actually reported it had become easier to find unskilled staff, up from a net 6 percent in June. These results reinforce that wage growth is likely to be nearing a peak, if it has not already.

Firms are continuing to shed staff and more looks to be around the corner. A strong focus on costs and business structures is underway. A net 11 percent of firms shed staff over the past three months, up from a net 3 percent in June. The next three months sees 7 percent of firms intending to cut back on staff numbers. The shedding of staff is across the board, with all sectors reporting declines. The services sector is the only one planning to increase staff levels over the next three months, while the labour shedding looks likely to intensify for retailers (merchants). The former is not all that surprising given that this sector is also the least pessimistic about their own activity. However, we suspect they will play catch-up to other sectors over the coming quarters, particularly if the global financial market turbulence persists. The unemployment rate is set to continue trending higher. But it is not just staff where cost cutting is occurring. Investment plans have also been shelved, with a net 20 percent and a net 16 percent expecting less investment in buildings and plant and machinery respectively. These results are broadly unchanged from the June quarter.



If there is anything encouraging to take out of today's survey, it is that pricing intentions and cost pressures have eased. A net 36 percent of firms increased their prices over the past three months, down from a net 47 percent in the June survey. Over the next three months, a net 28 percent are intending to raise their prices, a large fall from the 49 percent intending to raise their prices in June. Easing cost pressures, with falling oil prices as well as reduced staffing levels, maybe a factor in less price pressure. After a net 71 expecting higher costs in June, this has now fallen to a net 52 percent. However, it is more likely to be the case that businesses have come to the realisation that raising prices in a weak (and weakening) growth backdrop is a very difficult strategy to run. The intended drop in selling prices is more than the drop in expected cost increases and this bodes well for the near (and medium-term) inflation picture.



However, despite reduced costs, the profitability outlook remains very challenging. An economy heading backwards is never great for corporate earnings. Although easing, cost pressures remain high. A net 44 percent of firms reported a drop in profit over the past three months, while a net 23 percent expect a decline over the next three months. To be fair, this is a reasonable improvement from the net 40 percent

expecting a decline in June, but with it remaining well entrenched in negative territory, the renewed focus on costs is likely to continue for sometime.

Implications

For the RBNZ, today's survey will have certainly allayed some of their worries over medium-term inflation. It also justifies their decision to begin front-loading the easing cycle. We think it gives them more room to do this if they wish. For now, we continue to look for a 50bp cut on 23 October, but are starting to think about 75bps. The focus is clearly offshore and developments remain very fluid.

| | Q2 2007 | Q3 2007 | Q4 2007 | Q1 2008 | Q2 2008 | Q3 2008 | Decade Average |
|--|---------|---------|---------|---------|---------|---------------|----------------|
| Business Confidence - actual | -37 | -27 | -26 | -64 | -64 | -19 | -16 |
| - s.a. | -28 | -29 | -39 | -58 | -54 | -24 | -16 |
| Experienced domestic trading activity – actual | 8 | 0 | 10 | -7 | -22 | -34 | 8 |
| - s.a. | 12 | 2 | 6 | -7 | -18 | -32 | 8 |
| Expected domestic trading activity – actual | 9 | 15 | 14 | -10 | -23 | -8 | 12 |
| - s.a. | 13 | 13 | 12 | -8 | -18 | -13 | 13 |
| Capacity Utilisation (CUBO) | 0.9156 | 0.9134 | 0.9204 | 0.9262 | 0.9237 | 0.9079 | 0.9066 |
| Average selling price – past 3 months | 25 | 33 | 28 | 42 | 47 | 36 | 17 |
| Average selling price – next 3 months | 35 | 34 | 35 | 45 | 49 | 28 | 24 |
| Costs – past 3 months | 46 | 46 | 45 | 59 | 68 | 59 | 31 |
| Costs – next 3 months | 48 | 44 | 49 | 62 | 71 | 52 | 31 |
| Difficulty finding labour – skilled | -42 | -41 | -46 | -36 | -19 | -5 | -33 |
| Difficulty finding labour – unskilled | -26 | -19 | -33 | -22 | 6 | 16 | -11 |
| Investment intentions – Buildings | -5 | -6 | -8 | -18 | -18 | -20 | -9 |
| Investment intentions – Plant & Machinery | 3 | 3 | -3 | -15 | -17 | -16 | 1 |
| Employment intentions – past 3 months | 2 | 5 | 4 | 4 | -3 | -11 | 1 |
| Employment intentions – next 3 months | 11 | 12 | 14 | 0 | -6 | -7 | 4 |

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- Associate Member of Investment Savings & Insurance Association of NZ;
- Financial Markets Operations Association; and
- Institute of Finance Professionals.

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- Adjudicated bankrupt;
- Prohibited by an Act or by a court from taking part in the management of a company or a business;
- Subject of an adverse finding by a court in any proceeding that has been taken against them in their professional capacity;

- Expelled from or has been prohibited from being a member of a professional body; or
- Placed in statutory management or receivership.

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- Equity securities such as listed and unlisted shares;
- New Zealand and overseas unit trusts;
- Share in a limited partnership;
- Superannuation schemes and bonds;
- Group investment funds;
- Life insurance products;
- Derivative products including interest rate and currency forward rate contracts and options; and
- Other forms of security, such as participatory securities.

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- Providing a cheque payable to the relevant product or service provider and crossed 'not transferable'; or
- Making an automatic payment or payment through another electronic delivery mechanism operated by the Bank.

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Any investment money lodged with the Bank for the purchase of securities offered by the Bank, its subsidiaries or any third

parties will be deposited in accordance with your instructions, to your nominated account or investment. Such money will be held by the Bank according to usual banking terms and conditions applying to that account or the particular terms and conditions relating to the investment and will not be held by the Bank on trust unless explicitly accepted by the Bank on those terms. Any investment money or property accepted by the Bank on trust will be so held until disbursed in accordance with your instructions. Any investment property lodged with the Bank will be held by the Bank as bailee according to the Bank's standard terms and conditions for holding your property.

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