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Dear Client

### 2008: Get Ready For The Rocky Road Ahead!

Big talking point at summer barbecues: Just what is this guy John Key like? That's until Sir Edmund Hillary died. Was he the greatest NZer? Judging by the long shadow his death cast over the country, yes. Not just because he conquered Everest, or reached the South Pole against the odds, but for what he did in the following years, in helping the Sherpas of Nepal, as they helped him. We will not see the like again. The mood of the country, already introspective, darkened.

The refusal of the Royal Family to be represented at the funeral was a snub. It underlined a feeling of being alone, isolated, the monarchy an irrelevance. Hillary, a NZer, belonged to the world. He epitomised our sense of being part of the community of nations. His deeds spoke for NZ.

So who will pick up the pieces? NZers will be looking again at their leaders. It's make-or-break year for John Key. Give Helen Clark another term, and some say she will be there for life.

Can Winston Peters revive his party, and gain another life as NZ's elder statesman? We've learned never to under-estimate him. Clark is a master politician, In last year's Roll Call we named her politician-of-the-year, for holding together a crumbling Govt. But the electoral funding legislation could be her political nemesis.

Since then, the economy has gone ugly. Household budgets are under siege. Food prices are soaring, transport costs are surging, mortgage interest rates are hurting. Housing affordability is the latest political itch. The share market has taken a battering. The local market caught a chill from the sub-prime credit crunch in the US. Billions have been wiped from the wealth of NZers.

Finance companies are in strife. Could the currency be next? The NZ dollar has defied gravity for longer than most pundits predicted. If it's savaged by international currency traders, then watch petrol prices go through the roof, while the cost of other imports would add to already powerful inflationary pressures. It would expose NZ's Achilles heel: the current account deficit and huge levels of external debt.

But a lower exchange rate could be a significant boost for the struggling export sector. Dairy is having a good run, but beef, lamb, venison, fish, fruit and timber need a big (currency?) lift. World dairy prices have doubled in a year, and even a 50% fall would still leave them 50% above the level of a year ago.

The Asian growth story could be a saviour for NZ. A free trade agreement with China has now been negotiated and will be signed in April. It will be a feather in the Govt's cap. The benefits may arrive only slowly.

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The hard fact is NZ faces a tough year. No longer can politicians in the Labour-led Govt pull the wool over voters' eyes, and pretend the good times were all their own work. The economic cycle ran longer and more favourably than anyone might have predicted in 1999.

Have the fruits been squandered? Sure, the bureaucracy has expanded like a boil on the bum, but many of the problems NZ faced then are no better now. Productivity is low, infrastructure too often third-world, and the health system still not delivering everything those who need its services expect. Not to mention levels of violent crime, and social dysfunction.

Trans-Tasman Financial Markets - Exchange Rates

New Zealand				Australia			ASB
Forecasts	Latest	Mar-08	Jun-08	Latest	Mar-08	Jun-08	
USD	0.767	0.800	0.800	0.859	0.940	0.940	
EUR	0.524	0.556	0.556	0.628	0.653	0.653	
GBP	0.391	0.388	0.388	0.424	0.456	0.456	
JPY	81.7	96.0	96.0	104.3	112.8	112.8	
NZD/AUD	0.882	0.851	0.851	1.134	1.175	1.175	
Interest Rates							
90 days	8.73	8.65	8.65	7.15	7.20	7.15	
10 years	6.23	6.20	6.20	5.87	6.40	6.50	

Updated January 23, 2008

Is it time for new ideas and new solutions? Helen Clark can reasonably claim her Govt has created a fairer, more equitable society. The Cullen Fund for superannuation and KiwiSaver are important innovations aimed at offsetting the country's low household and national savings rates. High surpluses in the Govt accounts provide a buffer against shocks. But too often we see the "quick fix to life" mentality get in the way of a long term approach.

Meanwhile NZ struggles to keep pace with its trans-Tasman neighbour. The stream of NZers leaving for better-paid jobs on the other side of the Tasman has become a torrent. Business complains of the cost of ever-growing regulation, compliance, and taxation. The share of total taxes collected from personal and corporate income is high by OECD standards because NZ does not have a social security tax on wages and salaries.

Economy Size 2005	
GDP By Purchasing Power Parity - \$m	
1. USA	\$12,376.1
2. China	\$5,333.2
3. Japan	\$3,870.3
4. Germany	\$2,514.8
5. India	\$2,341.0
6. UK	\$1,901.7
7. France	\$1,862.2
8. Russia	\$1,697.5
9. Italy	\$1,626.3
10. Brazil	\$1,585.1
others ...	
13. Canada	\$1,133.0
14. Korea	\$1,027.0
15. Australia	\$671.5
57. NZ	\$100.7
Source: World Bank	

And competing with the rest of the world is also a struggle. NZ finds it hard to simply get things done. If you take the Chinese example, it is building a rail network the size of NZ's in a matter of a few years. This country lacks urgency and direction in a changing world. We still send logs overseas, rather than furniture. The nations we compete with are not standing still as they look for an advantage in the global market place.

The question is: Has Finance Minister Michael Cullen left it too late in the election cycle for reform of the personal tax structure? The woes of the international economy may spill over into NZ, and so swallow up any tax relief he offers to households. Given the squeeze from interest rates and rising food prices on household budgets, a \$20 a week tax cut may earn the Govt a derisive sniff, rather than any warm applause.

We think the country's tax system needs an overhaul from top to bottom, and if John Key advances a programme extending over several years not just of

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tax cuts but including a revision of work and welfare incentives, then he'll be on the right track. The country needs a tax system which helps to drive NZ's economic performance. Voters are interested only in their own "personal economy." Only if the rewards for working and living in NZ are better than those across the Tasman will we stop the drain on our key resources, including highly skilled workers and investment.

The FTA with China will thrust NZ into the midst of the Asian cauldron like never before. But do we have the technical infrastructure to compete? NZ needs to be in the vanguard of technology, instead of having to search for parts for primitive outdated switching gear. A small country should be able to have a high level of connectivity. Fast broadband must be made competitively available to all, and quickly. It is not just a matter of catching up, but trying to leap ahead of our Asian rivals, who are starting late, but with the very latest technology.

An area where NZ is forging a position of leadership is in sustainability. The country's stated desire to be a sustainable economy has created interest around the world. But talk must be backed with action, and policies must be developed which will turn the economy into a leader in this sector, rather than hold it back. What the country needs are incentives to go green, rather than more charges and taxes. There's also a pressing need to amend the RMA.

The infrastructure deficit is a huge problem. Voters want solutions to their problems. They want to see new roads built, not endlessly studied. They want a secure power supply at affordable prices. In short they want first world infrastructure services. The Govt must find a way to provide infrastructure which will serve generations to come, at an acceptable cost. The economic costs of poor infrastructure are enormous.

There is also a need to consider the fate of human infrastructure. NZ's productivity is low by OECD standards. The country has high labour utilisation, but output is not keeping up. A skilled labour force is an essential component of a first world economy, and both the Govt and business need to invest in skills development.

Many in NZ have only known boom times and a downturn in global economic additions will very quickly sort out the fair weather sailors in their ranks. The majority of NZ households will see their disposable incomes go backwards this year. The NZ consumer looks more exposed than those in other countries such as Australia or the US. The housing market will weaken, and retailers will find it tough going. Surging food bills risk a sharp backlash against an incumbent Govt.

Opinion polls as 2007 ended suggested many NZers are looking for a change in Govt. Once the mood takes hold, there's little a Govt can do to stem the tide as the Howard Govt found out. The difference, perhaps, is NZ's MMP system. It could throw up the anomaly of National winning the most votes but leaving it without the allies to form a viable coalition.

A true test for John Key's political skills will be to convince a majority of voters he can manage a coalition that might embrace parties as diverse as ACT,

Broadband Penetration	
Subscribers per 100, rank	
June 2007	Dec 2007
1. Denmark	1. Denmark
2. Holland	2. Holland
3. Switzerland	3. Iceland
4. Korea	4. Korea
5. Norway	5. Switzerland
6. Iceland	6. Norway
7. Finland	7. Finland
8. Sweden	8. Sweden
9. Canada	9. Canada
10. Belgium	10. Belgium
11. U K	11. U K
12. Australia	12. Lux'bourg
13. France	13. France
14. Lux'bourg	14. Japan
15. USA	15. USA
16. Japan	16. Australia
20. N Z	20. Italy
21. Italy	21. N Z
Source: OECD	

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The Main Report Current Forecasts

↓	<b>Equities NEW FORECAST</b> US growth concerns weighing on global markets near term.
↓	<b>Inflation NEW FORECAST</b> Commodities, carbon trading, potential tax cuts boosting inflation.
□	<b>Official Cash Rate</b> RBNZ balancing inflation vs. downside global growth risks.
□	<b>Commercial Construction</b> Value of work remains at a high level, but growth is flat.
□	<b>Business Confidence</b> Activity expectations suggest modest NZ growth.
↓	<b>Household Lending</b> Moderating on tighter monetary conditions.

Complete Economic Outlook at  
ASB Quarterly Forecasts

United Future and the Maori Party. We have seen hints he may be able to deal with these disparate parties.

If NZers believe their country has moved on to the wrong track, John Key's task is to provide them with a road map for a better future. But while those NZers may be demanding black-and-white solutions, Key can hardly frame those solutions in black-and-white terms - if it means cutting all bridges to potential coalition partners. So this year will be a formidable challenge for our leaders: Clark a proven performer against Key the wannabe PM.

While leadership at a political level will be crucial, the Cabinet, and Shadow Cabinets will also be a key factor. Helen Clark's team is looking tired and bereft of ideas, and new talent is not living up to expectations. John

Key is suffering much the same fate with many in his shadow line-up still veterans of the Shipley Govt. Change will not come easily to political veterans.

The political equation has many variables. Will Winston Peters go back to fight on the Tauranga beaches? Will the Maori Party make further gains? Nandor Tanczos is retiring from politics, ostensibly to shoe-horn co-leader Russel Norman into Parliament before the election. But will that help the Greens over the threshold?

NZers have seen the winds of change blowing through the US system, with Barack Obama making a compelling case for a new vision. John Key is NZ's Obama, but like Obama, he has not yet delivered any real substance. He is a successful businessman, but this alone does not provide the necessary skill set for leading the country. Voters want to see what alternatives Key will offer on health, education, welfare, infrastructure, climate change and of course tax. We are challenging our leaders to show us what is possible, not what is probable, looking out a decade, rather than a year.

At this point, the odds are on change. Let's hope it's the kind of change NZers really want: rather than change forced on them by the harsh demands of a global credit crunch and international recession.



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