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Comment
The free trade agreement with China is due to be signed next week. The CTU has consistently raised concerns about these negotiations over the last 3 years and has made comprehensive submissions, met with MFAT officials on many occasions, and signalled our key issues in discussions with Ministers. As the negotiations neared a conclusion we focussed mainly on three areas: the phase down of tariffs on clothing, textile, footwear and carpets as well as whiteware; the memorandum on labour issues, and; temporary migration.

In terms of tariffs, we want to see exactly how long the phase down is, assess the likely impact on jobs, and what the different time periods are between NZ and China tariffs each going to zero. For the labour clause the key issue is whether the wording has teeth and can be enforced if there is a complaint with reference to ILO core standards about the specific labour conditions that underpin the goods and services traded under the agreement. In respect of temporary migration, we have opposed binding migration commitments being made under a trade agreement to apply regardless of unemployment levels in New Zealand. Temporary migration is included in the trade deal because the Mode 4 category of services trade is defined as the movement of 'natural persons'. We will be watching for the cap on temporary migrants, the occupational categories, review mechanisms and any other conditions which apply.

Overall, we recognise that China is already here and that a free trade agreement only makes a difference at the margin. There will be benefits particularly from easier access to a growing Chinese market. That will have an upside job impact. But greater economic integration with China may also mean that more and more employers go up to China to check out whether they should relocate. It is hard to predict the long term impact. The agreement still has some steps to go through before it is implemented. But we need to ensure that those that suffer any adverse effects are supported. After all – if the benefits are so considerable - as some claim, don't we need to ensure they are fairly distributed?

Meanwhile, the advocates of free market capitalism have got a bit more explaining to do after the events of the last few months. Martin Wolf, chief economic commentator of the *Financial Times* said last December that, "What is happening in credit markets today is a huge blow to the credibility of the Anglo-Saxon model of transactions oriented capitalism'.

And *The Economist* noted recently that "for the critics of modern finance, Bear's swift end on March 16th was the inevitable consequence of the laissez-faire philosophy that allowed financial services to innovate and spread almost unchecked. This created a complex, interdependent system prone to conflicts of interest. Fraud has been rampant in the sale of subprime mortgages. Spurred by pay that was geared to short-term gains, bankers and fund managers stand accused of pocketing bonuses with no thought for the longer-term consequences of what they were doing. Their gambling has been fed by the knowledge that, if disaster struck, someone else - borrowers, investors, taxpayers- would end up bearing at least some of the losses".

It is not a short story – and there is more to come. Wall Street banks, brokerages and hedge funds may report $US460 billion in credit losses from the collapse of the subprime mortgage market, or almost four times the amount already disclosed, with estimated losses throughout banking and finance of $US1.2 trillion.

Deregulation of the US financial system from the 1980s abolished the legal limit on interest rates. This allowed sub-prime mortgages with no requirements for documentation of income; mortgages that cover 100 per cent of the house price; and 'teaser rates', where payments during an initial period do not even cover the interest charges and where the difference is added to the capital borrowed. The interest rate on sub-prime mortgages is usually adjustable, and such loans are attractive for lenders because the rate is on average about 5 per cent above the rate on government bonds.

The share of sub-prime mortgages in total mortgage lending increased from around 5 per cent in 2001 to 14 per cent by 2005. But the banks in some case no longer held mortgages on their own books but grouped them together into a bundle which was then sold as a bond on the capital market. This is securitisation. By January 2007, these bonds were worth $5.8 trillion with $850 billion held by offshore interests.

But bonds based on sub-prime mortgages do not receive the highest credit ratings. So investment banks developed a new type of instrument known as a collateralised debt obligation (CDO). This transforms securities with a lower rating, such as those based on sub-prime mortgages, credit card debt, or car leasing agreements, into securities with the very highest rating. But the rating agencies charged double fees for rating CDOs because of the complexity of the task. A tidy earner - and their cut in the merry-go-round.

But CDOs were not the only new devices. Another one was something called Structured Investment Vehicles (SIVs) which included some sub-prime based securities. SIVs allowed banks to hold these assets off their books, financed by selling short-term securities, and returning good profits until investors became averse to anything linked to sub-prime mortgages. The SIVs were faced with a funding crisis as they could no longer sell new issues of asset backed commercial paper.

However, the SIVs had established credit lines with the banks precisely to cover this eventuality, but they had rarely been used. But now, with the large sums involved, banks that were suspected of being exposed to demands arising from the breakdown of the asset backed commercial paper market found that other banks were reluctant to lend to them. This contributed to less liquidity and is driving higher interest rates – including in New Zealand as banks through most of the world pay more for credit. And we also know that one Australian bank, the ANZ, expects losses of $US200 million from exposure to US bonds.

As Trevor Evans from the Berlin School of Economics (whose article I have drawn from above) has explained about the USA, “mortgage lenders employed hard-sell tactics, pushing many households to take on debt they couldn’t afford, which the banks then sold on in the form of mortgage-backed securities which, in turn, were transformed into unfathomably complex CDOs designed to obscure the true risks from view”.

Also exposed by the credit crunch is the huge leverage used by these investment banks. Goldman Sachs is using about $US40 billion of equity as the foundation for $US1.1 trillion of assets. At Merrill Lynch, the most leveraged, $US1 trillion of assets is leveraged by around $US30 billion of equity. The average gearing is assessed at 32 times equity.

And now we see a major argument about the role of the Fed. Tom Palley has strongly criticised excessive representation of Wall Street interests within the Fed which he says displayed massive policy failure in its refusal to address asset price bubbles yet is now providing risk capital to the likes of Goldman Sachs at paltry interest rates that confer a significant subsidy.

He says “these subsidies are a travesty. Goldman Sachs, Lehman Brothers, and Morgan Stanley are extraordinarily profitable companies. They have also been the drivers of the worst trends in the American economy over the past generation, pushing excessive CEO pay that has spread like a cancer throughout corporate America, even reaching into universities and non-profits. Additionally, they have pedalled the shareholder value paradigm that has pushed companies to emphasise short-term gain over long-term investment, and contributed to ripping up America's social contract. Meanwhile, their business model has promoted speculation that is behind repeated asset and commodity price bubbles”.

And who gets hurt most? By December 2007, 994,000 households were facing foreclosure affecting some 2.5 million people. About 15 million households have mortgages worth more than the house. Yet Merrill Lynch allowed its chairman and chief executive, Stan O’Neal to retire as chairman and chief executive, rather than sacking him, so he qualified for a $US161 million departure package.

Consensus forecasts[1] published by NZIER
The consensus forecasts were updated in March 2008.

March Years percent	2008	2009	2010
GDP	3.0	1.7	2.4
CPI	3.4	3.0	2.8
Wages (QES)	4.1	4.1	3.7
Employment	1.5	0.7	0.9
Unemployment	3.7	4.0	4.3

Economic Snapshot
Consumer prices rose 1.2 percent in the December 2007 quarter, and were up by 3.2 percent annually. The next CPI update is on 15th April 2008. Food prices rose 0.8 percent in February 2008, and increased 5.2 percent over the past 12 months. Grocery food prices have risen 9.0 percent in the last year. Unemployment is at 3.4 percent. Māori unemployment is 7.3 percent and Pacific peoples' unemployment is at 4.7 percent, compared with 2.3 percent for European/Pākehā. The minimum wage is now (from 1st April) $12.00 an hour and $9.60 for new entrants aged 16 or 17 for the first 3 months or 200 hours whichever ends first[2]. Ordinary time wages, as measured by the Quarterly Employment Survey (QES) for December 2007, were up annually by 4.2 percent (4.0 percent in the private sector and 5.0 percent in the public sector). The QES showed that the average ordinary time hourly wage is now $23.29 ($21.73 in the private sector and $29.49 in the public sector). The next update of wages data is on 5th May, 2008. Economic activity increased by 1.0 percent in the December 2007 quarter, compared with 0.5 percent in the September 2007 quarter. In the 2007 calendar year the economy grew by 3.1 percent, up from 1.5 percent growth recorded in 2006. The Official Cash Rate (OCR) remains at 8.25 percent.

Wages
There are various commentaries which argue that the tight labour market is resulting in wage increases that are up on recent years. Westpac last month referred to "rampant wage pressures". This is not supported by the statistics and I note that the Treasury said recently that "With the continuing tight labour market, wage growth in the December quarter remained elevated but appears to have passed its 2006 peak". And NZIER said in its commentary on the March 2008 Consensus Forecasts that the outlook for private sector wage growth "remains weak" with a forecast of 4.1 percent for 2007/08 and 3.7 percent for 2009/10 compared with wage growth of 5.3 percent in 2006/07.

Economic Growth
The economy as measured by GDP grew by 1 percent in the December 2007 quarter – higher than market predictions. Annual growth was 3.1 percent, double the 1.5 percent rise in 2006. Dairy and petroleum exports and higher

[1] The consensus is made up of the average of forecasts from NZIER, Berl, ANZ- National Bank, ASB Bank, BNZ Bank, First New Zealand Capital, Deutsche Bank, UBS, Westpac, Reserve Bank of New Zealand and Treasury. They are done every 3 months which means that we sometimes will know actual figures for some of the forecasts.
[2] If the worker is however supervising or training other workers the $12 minimum applies.

business investment contributed to the 1 percent growth in the December quarter. Statistics NZ say that real gross national disposable income increased 5.1 percent in the year ended December 2007. However the outlook is less rosy with a consensus forecast of 1.7 percent for GDP growth in the March 2009 year, some forecasts of just above 1 percent growth for calendar 2008 with the possibility of two negative quarters in the last half of the year. The BNZ for instance said last week that it is expecting quarterly growth of 0.1 percent for March 2008, a flat second quarter and a better than even chance of slight contractions in the final two quarters for 2008. Their printed forecasts add up to just 0.3 percent GDP growth for 2008. Workers are being hurt by higher food and petrol prices, higher rents for some and higher interest payments for others at a time when the value of their house is declining – slightly at this stage but with forecasts of 5 to 10 percent falls for the year. The drought is estimated as costing $1.2 billion. *The Economist* said on 28th March about the NZ economy that "We expect high fuel and mortgage costs to dampen private consumption growth by cutting into debt-laden households' disposable income".

Despite good export returns, the prospect of tax cuts, a strong Budget, and the view by many that the end of a long cycle of growth would have a soft landing before lifting off again, this is nevertheless a worrying outlook which justifies the Reserve Bank reducing the cash rate by 0.5 percent on 24th April. This would be the best course of action in these circumstances but most commentators continue to support a rate cut being delayed to the end of this year or early 2009. Having said that, after the latest business survey showed a pessimistic outlook, the BNZ said that they expected three rate cuts of 0.5 percent starting in December, and ongoing cuts after that.

Tax, Benefit and Super Changes
A number of changes apply from 1st April 2008 including a cut in the company tax rate from 33c to 30c, a new R&D tax credit of 15 cents in the dollar, compulsory employer contributions of at least 1 percent to KiwiSaver with a reimbursing tax credit of up to $20 a week, a lift in the minimum wage to $12 an hour and a 3.18 percent rise in benefit payments.

Government Accounts
There was some confusion in the latest set of Government accounts after a further check on a $700 million shortfall in tax revenue compared with the forecast resulted in a revision as IRD revealed a mistake had been made to the tune of $600 million. This meant that the operating balance showed a very small surplus of $200 million. This was however still $3.6 billion lower than the forecast. This was due to $2.5 billion lower than forecast returns on the financial asset portfolios of the NZ Super Fund ($1.5 billion lower than forecast), ACC ($0.7 billion lower than forecast) and EQC ($0.3 billion lower than forecast), and a $1.0 billion more than forecast loss on the revaluation of the ACC claims liability. The OBEGAL (Operating Balance Excluding Gains and Losses) was in line with the forecast surplus of $3.6 billion. Gross debt was 18.5 percent of GDP and net debt was 5.4 percent. The significance of the revision was that much lower tax receipts than forecast ($700 million down) suggested a rapidly slowing economy rather than a modestly slowing

one as indicated by being $100 million down. Given measurement issues in the context of around $32 billion tax revenue, such a small difference from forecast is not that significant.

Housing and Property

REINZ figures show that median house prices fell from $340,000 in January to $337,500 in February, leaving it just 0.74 percent ahead of the February 2007 median of $335,000 and considerably below the $352,000 median price in November 2007. Quotable Value's February statistics for the residential property market report a 7.7 percent growth in national property values over the past year, down on the 8.9 percent growth reported in January. The average New Zealand sale price increased to $393,240 this month (from $390,636 last month). The Fairfax Media Home Loan affordability report shows the average 2 year fixed mortgage rate rose just under a quarter of a percentage point to 9.56 percent in February, which almost cancelled out the effect of a 0.7 percent fall in the median house price to $337,500. Meanwhile the number of building consents continues to decline. There were 1,874 new housing units authorised in February 2008, 218 units fewer than in February 2007.

Trade, Balance of Payments and International Investment Position

The current account deficit for the year ended December 2007 was $13.8 billion (7.9 percent of GDP). This compares with a deficit of $14.0 billion (8.6 percent of GDP) for the year ended December 2006. The improvement is due to higher exports including petroleum from the Tui field. However, the investment income deficit of $12.5 billion is 90 percent of the current account deficit which includes profits to overseas owned companies and bank borrowing to fund mortgages. New Zealand's net international liabilities were $152.4 billion at 31 December 2007. The monthly trade balance for February 2008 was a surplus of $258 million, with exports up 30.3 percent ($864 million), the largest percentage rise for any month since January 2001 and the largest value increase ever. Milk powder, butter and cheese rose 72.1 percent in value but only 1.1 percent in quantity compared with February 2007. The value of merchandise imports for February 2008 rose 16.1 percent ($479 million) compared with February 2007. The rolling annualised trade balance showed a $4.4 billion deficit compared with $5.8 billion for the February 2007 year and $7.3 billion for the February 2006 year.

Retail Sales

In January 2008, seasonally adjusted retail sales increased 0.3 percent ($18 million). This follows a 0.1 percent increase in December 2007.

Migration

In the year ended February 2008, there were 83,300 permanent and long term arrivals, up 1 percent from the February 2007 year. There were 78,700 departures, up 13 percent. As a result, net migration was 4,600 in the February 2008 year, down from 13,200 in the February 2007 year. There was a net inflow of 6,900 migrants from the United Kingdom, down from 10,500 the previous year. There were also net inflows of 4,200 from India, 3,200 from the Philippines, 2,600 from Fiji, 2,100 from South Africa, 1,900 from China, and 1,600 from Germany. The net outflow to Australia was 29,600 in the February 2008 year, compared with 22,200 in the February 2007 year. This is the highest annual net outflow to Australia since the July 2001 year (30,000). 4700 people left New Zealand to live permanently in Australia in February, of whom 4300 were New Zealand citizens. The flow in the other direction from Australia to New Zealand was 1200, of whom 742 were New Zealanders returning. The net result was a flow of 3500 migrants from New Zealand to Australia.

Popular Schemes

More than 100,000 parents have signed up for Paid Parental Leave since the policy was introduced in 2002 and over 500,000 have enrolled in KiwiSaver just 8 months from the launch, more than double Treasury projections. Also 370,000 families received the Working for Families tax credit in the last tax year.

Labour Productivity

Labour productivity in the year ended March 2007 increased by 0.5 percent for the measured sector. This was driven by output growth of 1.4 percent and labour input growth of 0.9 percent. Labour productivity rose by 1.1 percent on average each year in the 2000 to 2007 period. This compares with 2.9 percent in the 1985 to 90 period when labour inputs fell and there were large scale redundancies and rising unemployment. Statistics NZ say that “lower growth of labour productivity, as shown in recent years, could be explained by several factors. One influence is a change in the skill composition of the employed labour force, due to skill shortages resulting from a tight labour market”.

Working Women

Women’s participation in the labour force continued to rise in 2007, meaning the gap between male and female participation is the smallest since the Household Labour Force Survey began in 1986, increasing from 59.2 percent in December 2002 to 61.9 percent in December 2007. Importantly, a significant proportion of these women are in part time work, 34.5 percent compared to the OECD average of 26.4 percent.

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