



Economic outlook for 2011

The global situation:	1
And here in New Zealand:	3
The effect on the marketplace and the business	5
What you should do	6
The January shark	7

The global situation:

Who is in charge of the world at the moment? Power doesn't rest in Washington, Brussels or Westminster any more. Nor does it really reside in Beijing or Moscow either, because the leaders there know they have to be careful. If there is anyone in charge these days it is the ratings agencies and bond buyers, but they are the least bad of a feeble bunch. There is a vacuum of leadership except for the control exercised by some financial institutions – but they have no inclination to direct, lead, achieve or unite, only criticise. This is the last thing the world needs in 2011, but that's where we are!

Devaluation could become a race. This is of course a lose-lose scenario once it becomes too contagious but the only way individual economies can recover some element of competitiveness is through devaluation. Even if they were able to agree (which they cannot), and trust each other (which they will not) and fully control the process (which they cannot) it is still likely that someone would have to give into temptation and begin to devalue due to domestic economic pressure. Even if deliberate actions to devalue are overlooked, there are the consequences of Quantitative Easing to consider..

World needs inflation. As long as government debt grows at the same rate as GDP, then the government's balance (debt as a proportion of GDP) remains static. This equation has allowed governments to run consistent deficits – it is not the debt in dollar terms that matters, it's the debt in relation to GDP. This is why it really hurts when growth stalls – two years of a flat economy takes 5% off what the government could normally have spent to buy more votes. Now every Government needs a healthy dose of inflation for several years to reduce the value of its debts, encourage spending now and reduce consumer indebtedness. If governments were still in control of their own destiny (as they used to be), that would be easy. However, if their Central Bank has an inflation only target, or if the bondholders punish them when they try and roll over existing debt, then that option does not exist. Expressed like that, the financial stability we have cherished for the past two decades can now be seen as a strait-jacket that will ultimately suffocate..

Demography. This financial strait-jacket described above in which most governments now find themselves would take time and pain to be freed from without further encumbrances. However, when you add to this the ticking time-bomb of the retiring baby-boomers, escalating health-care costs and still rising lifespans, the task of those

governments has just been made even harder. Hard decisions have to be made whose benefits will not be felt until way after the length of a Parliamentary term, and current governments are simply too embattled in the short-term to tackle this additional struggle.

Protectionism. A lot of countries have become more skilled at 'subtle protectionism' – by boosting their own pedantic labelling, technical requirements or approval processes. These powerful barriers to entry discourage importers whilst ostensibly remaining within free-trade guidelines. Even persistently delaying customs clearance can be sufficient to discourage new entrants and preserve domestic suppliers. Expect to see a lot more of this, especially from the Asian countries who have been fine-tuning it in recent years.

Austerity packages. There is a substantial element of conjecture about the long-term effect on domestic spending of reducing government expenditure and the next two or three years will show how critical – or inefficient and unhelpful – government spending is to growth. A few gravy trains will deservedly come to rest in their sidings but whether the velocity of money will be slowed by austerity packages will be the growing question of 2011/2.

Europe. Will it? Won't it? Just how much patience do the Germans have? How broke does a country have to be before it can exit the Euro? How do you change currency overnight? One could ask Zimbabwe or Argentina who have some practice in the field – which is far from inspiring! The reality is that no-one knows any answers but anyone can foresee that the pressures could easily become unstable. Some towns in Germany are already using a local informal currency and the financial support required for the bailout is being challenged in Germany's constitutional court.

It may take more than the iron will of Fraulein Merkel to hold the situation together – and whilst Germany is also Europe's biggest creditor (and breaking off would devalue those foreign debts to Deutschland's detriment) there may come a time when they are unwilling or unable to throw more good money after bad. More than half of Europe is in dire straits and The BMC is unable to visualise a situation where the weaker countries have righted themselves whilst remaining tied to a high Euro. We now predict that there is a significant possibility that Germany (accompanied by Holland and Austria) may break away. Should that happen, the French reaction will be a sight to behold.

Climate change. Again in Europe, the recent cold snap has re-ignited speculation concerning the demise of the Gulf Stream, the warm current which keeps N Europe's temperatures much higher than similar latitudes elsewhere. If it fails (which has been predicted as an early consequence of global warming), then a huge proportion of the world's economy will buckle under the weight of providing for an abrupt worsening in climate for which it lacks the infrastructure. However, since the failure of Copenhagen and the retreat of virtually all Governments from emissions trading due to their domestic woes, the only thing certain about climate change in 2011 is that nothing will be done to stop it.

An entertaining aside - Palin and Peters. For this author, the temptation is too great not to dwell on the mighty Mrs Alaska as an entertaining break from weightier matters. Love or hate her (and most men find her compelling, however galling that may be for some people) - she does have the knack of stating exactly what most people feel. It may be easy to knock a slender command of geography and therefore confusing the names of South and North Korea but no-one doubts she knows who the good guy is and what to do with the bad guy – which is the purpose of the whole exercise, ultimately!

That rough-edged conviction is appealing, particularly given earlier comments about the absence of global leadership. Increasingly people believe Obama's problem is that he thinks only he knows the answer – and as Palin said last week, 'we need a commander-in-chief not a professor of law'. The kind of jingo-ism she creates can bolster morale in a way that no-one else can and that is what America needs – morale - so 2011 will be fun to watch from this side of the Pacific.

That said, we have our own Palin in the incorrigible Winston Peters (though the effect of his aesthetic charms is now confined largely to females over 50). He pops up here (as he often does, pop up) in this paragraph because he shares with Palin that knack of saying what a lot of people feel in the right way and neither of them should be understated as a result. Some might say though that the difference is that whilst Palin might bend the truth about her hunting skills, Peters and the truth are so far away from each other he might need to use a helicopter (without paying for it again) to find it....

Vicious circle

The BMC is in the early stages of assessing whether the Western world is teetering on the edge of a vicious circle. It is the owners of assets who hold all the power now and demand to keep those asset values high. However house prices are increasingly unaffordable or generate levels of debt way beyond historical norms. Those house prices are now static and will soon be affected by a lack of demand from demography. The only way to restore affordability would be inflation but as previously stated this will not be tolerated by the asset owners. Stagnation is the likely outcome – house prices need to move to generate domestic activity and growth but they cannot move due to weak demand and a lack of affordability. This concept is not fully developed and will be explored more in the New Year.

And here in New Zealand:

Before discussing the economics it is worth considering how resilient the national morale has been. This country has endured the Christchurch earthquake, the devastation of the kiwifruit industry, the Pike River disaster and now drought before the Christmas tree is decorated. Only a few parts of the country are unaffected and it must be said that national morale has withstood these blows remarkably well – which is a positive sign in itself.

Last year we predicted substantial **variations around the norm** – for an average growth of 1% say, there would be an unprecedented number of businesses doing –

MINUS 19% averaged out by a similar number achieving PLUS 21%. That was correct and will not change for this year. Many markets have not completed the structural change that is necessary and the substantial proportion of inflexible enterprises ensure that low-margin markets with excess capacity persist in many areas.

However there will be good news in the end. Commodities are selling well, the government is doing its best to help and businesses have adjusted to their new, less fertile environments – grudgingly and not completely - but they have adjusted. All that shareholders and Directors want for Christmas is certainty; most would happily trade a slightly lower level of revenue for the blithe confidence of four years ago that next month would be as good as the month before. The BMC believes that despite the global uncertainties, business in New Zealand will finish 2011 with that confidence substantially higher than when the year started.

Spring next year. The BMC has encountered surprising levels of optimism that the Rugby World Cup and/or the next election could be the spark that is needed to restore higher rates of growth. We do not believe that each event on its own is a sufficient trigger but we do observe that people can only go so long without concluding they have to generate their own optimism. We suspect that people will make these events and this period into one to drive expectations and confidence upward, simply because people will have had enough (3+ years) of the absence of a specific feel-good reason.

Cashflow. To reinforce the previous paragraph, the cash positions of most businesses at 31 August next year will decide the destiny of just about everything except the Webb Ellis trophy itself. This year there was a pronounced slackening of demand well in advance of Christmas and then an improvement again as businesses found their cash position to be better than twelve months previously. If that upward trend continues and businesses have greater confidence to undertake purchases made in September 2011 – and therefore mainly paid by early November – then this feel-good factor will enhance the RWC excitement and may shape the outcome of the election.

Gentle is the new norm. Accepting the arguments above for an improvement in the economy does not entail accepting a level of economic activity at the giddy heights of '06 and '07. Try and visualise a situation where construction of that quantity re-starts and twenty minutes can elapse without inspiration. Businesses – and citizens – will have to consider that New Zealand may persist in a period of steady, certain - but far from high - growth. There will not be exceptional months to clear that accrued tax bill as if by magic, there will be instead the need for diligence, discipline and dedicated husbandry of the resources of the business.

Govt mandate. Rarely have Western democracies seen such government by pragmatism not personality. Love or hate their policies, the government has gone about its business sensibly and quietly and – most believe – paying heed to voters feelings it may have misinterpreted. It is very, very hard to dislike John Key personally and this gives the government a lot of latitude to test public feeling without altering it.



The upcoming election should be a straightforward affair (given the failure of Labour to present a new vision for itself) - except for the vagaries of MMP. Hide and Peters both have the ability to take big chunks out of the National Party's party vote and it is hard – though not impossible - to imagine the Maori party alliance remaining on the same terms. Whilst the BMC is unable to predict the best strategy to re-election we are certain that Mr Key can. The country can look forward to watching this scenario play out over the coming months.

Additionally, there is one good reason why The BMC believes fervently that the colour of our government must remain blue and that was – sadly - best stated by Len Brown. He recently asserted that “when Auckland thrives, New Zealand thrives”. Likeable man and gifted crowd-pleaser that Mr Brown is, until prominent socialists understand that the productive capacity (that sells the things that foreigners buy) is largely located elsewhere and the purpose of Auckland is to enable and support those producers then the economic future of this country simply cannot be entrusted to them.

Currency. There is no right answer for the currency. Higher oil prices balance exporting earnings and the only way NZ could affect its currency is to restrict capital flows to prevent trading on higher interest rates (a smaller problem than it was). That will not happen and the NZD will bob like a cork in the stormy seas of global devaluation, should things get that far. Businesses must run scenarios based on good/bad/average FX rates and plan for the overnight demise of the Euro. The Australian dollar will stay strong and the US dollar could be a wild ride; importers would be unwise to reduce margins at all on any products priced in USD. Expect to see some arbitrage with potential wild swings in major currencies

The effect on the marketplace and the business

Markets

Our comments of twelve months ago – that some markets will remain weak for the long-term in New Zealand – hold firm. Margins and innovation are still held down in many areas by inefficient firms operated without a succession plan by exhausted owners. Other markets enjoy high barriers to entry and are dominated by a small number of large players, giving the average NZ business only a certain number of options.

Margins

This year margins will be eroded in a greater variety of ways – whereas reduced prices (through customer negotiation) have been the primary cause of margin erosion in the past couple of years. In 2011, watch out for cost pressure, both direct cost and in particular the minor components of your COGS (freight [fuel – its going up again], FX, over-time, packaging) combining with high single-digit increases in your direct cost to take a 4-5% chunk out of margin without price increases across the board.

Staff

The employment market remains sufficiently inconsistent that employers retain the upper hand. The business world eagerly awaits the reminder of the changes to employment law to filter through, restoring the right decision to a position of ascendancy over perfect process.

THE BMC

BUSINESS MANAGEMENT CONSULTANCY

0508 THE BMC

What you should do

Be positive

Things are better than 12 months ago and while there are no signs in the stars that the situation will improve dramatically in the next 12 months, it should continue a gentle upwards trajectory. Your attitude can be a competitive advantage – there is a world of difference between desperately hacking at the ball and being hungry for it and now is the time to commit to being the best at what you do.

Visualise growth

If you intend that your business be in a higher gear, you have to be able to visualise what that would look like – what each step would look like and how you would take it. Take this opportunity at the start of the year to set the scene, to draw the picture of that achievement and then make that into a plan. This is the only time when you may have the time to do that so act now.

Consider diversification

Look hard at adjacent markets (maybe even purchasing others) as organic growth alone will not set the world on fire yet. Consider acquisition, or ask your best customers where they wish they could get better service.

Make service a priority

People are tired of things being hard now and they will respond to good service. A lot of people have now learnt that buying cheapest is not always the cheapest solution. Walking the customer through every stage to make things work smoothly for them and ensure good delivery on time will reduce their risk, pay dividends and earn you future loyalty.

Also for your customers, not being forced to buy the very cheapest option is a feel-good factor for them. It implies to them that they have taken a step back to higher levels of success because they can choose to work with who they want to, not who they are forced to. Give them reasons to justify accepting the supplier they want – whether it be quality, compatibility, DIFOTIS, warranty, reliability, specification assistance – but give them something to justify your price, something to prove they will be better for it in the long run and they are more likely to take it.

Monitor your data

Not being able to get the right information immediately on profitability, forward workload, your current balance or customer management is simply unacceptable in this decade. When opportunities are scarce and margins tight, knowledge is power and businesses who appreciate their competitive advantage lies in managing complexity and managing their data – even if they only turn over a couple of million dollars – will be the winners.

Pricing

It is a changing world and businesses are to a degree entitled to approach each negotiation from a fresh perspective every time. If you have accepted a tough solution in the past, you should not have to restart from the same lower level in a subsequent

negotiation. Share your pricing fluctuations, consciously develop your negotiating strategies and do not accept having last month's conditions forced upon you automatically every time. Assume the worst from some foreign currencies and see profit made on some FX as self-insurance for later losses.

Productivity. 24hr connectivity does not mean efficiency. It does not mean profitability. It does prevent the considered thought that does lead to efficiency and productivity. It does lead to burnout, cynicism and a lack of prioritisation. It does teach people not to delegate, or to prepare, because they can always be contacted. This strays beyond an Economic Outlook and will be the subject of a separate article in due course but in 80% of cases **if Apple had never been invented** and therefore managers spent more time understanding and monitoring their own business system and less time surfing the internet or sending rash ill-considered replies from tiny keyboards **then New Zealand would enjoy greater productivity.** While the HBR and other august sources have many good articles on the subject, we highly recommend a piece from closer to home – from our very own University of Auckland Business Review:

<http://www.uabr.auckland.ac.nz/files/articles/Volume13/v13i2-connectivity.pdf>

Watch out for the Euro!

If you deal in the Euro you simply cannot afford not to plan for its collapse. Consider the potential and likely impacts on your supply chain (or customer base) in the event of:

1. Price uncertainty
2. Currency collapse (would your suppliers run out of their raw materials)
3. Interrupted supply
4. Strike action
5. Inability to conduct financial transactions

No-one knows what might happen, but being prepared will give you the edge. Do not see this as an inward-looking exercise – if your competitor is more reliant upon Europe this may present you with an opportunity to gain market share!

The January shark

The activity in the Red Sea has been a godsend for our favourite paper – and we were impressed by the use of Orca last year whose fins looked similar to a shark when the paper was viewed from a distance - therefore driving readership and advertising revenue! We expect to see three front pages between 1 and 17 Jan relating to marine life and some of them from Australia or Egypt (if that continues). We do hope that we don't see any tasteless speculation on the causes of Pike River over the festive season – that community should be left in peace for a while.