

### This Week

The release of Budget 2010 last Thursday was generally well-received. The focus was on the overhaul of the tax system, with the reduction of income taxes across the board, increase in GST to 15%, and removal of the ability to claim depreciation on buildings garnering much attention. These changes are aimed at minimising tax distortions which affect work and investment decisions. In addition, the improved economic outlook results in a slightly better net debt outlook and thus reduces funding requirements over the period to 2014.

This improvement in the net debt outlook is welcome at a time when governments globally are under increasing scrutiny over the size of their fiscal deficits. Global markets have been dominated by continued fears that the Greek government will default on its debt and that problems will spread to other European economies. Overall, the European sovereign debt crisis has highlighted the risks of unsustainably high government debt. In contrast, ratings agencies Standard & Poor's noted that NZ has "an achievable and believable path to return the operating position to surplus" following the release of the Budget.

The broadening of the tax base will help boost the Government's tax revenue over the medium term. Broadening is in the form of higher GST, removing tax depreciation for all buildings, removing front-loading of depreciation and tightening thin capitalisation rules. The reduction of the thin capitalisation "safe harbour" threshold for inward investment from 75% to 60% means that foreign-owned companies will be able to claim tax deductions for interest payments on debt up to 60% of their local asset value. This goal is to ensure income is taxed in NZ, where it is generated, rather than offshore. In sum, revenue generating changes are expected to more than offset the decline in tax revenue from cutting income taxes and the corporate tax rate.

The Treasury's forecast of annual CPI inflation spiking close to 6% has served as a timely reminder that inflation pressures is once again building up in the NZ economy. Granted, the spike is largely driven by a range of one-off Government charges, which includes a rise in tobacco taxes, higher ACC levies, implementation of the Emissions Trading Scheme and rise in GST. However a high headline CPI outturn will test the key assumption that there will be no second-round effects, in the form of changes to wage and price setting behaviour. Future inflation expectations survey results will provide important insight into how contained inflation expectations are. We will receive the June quarter reading of inflation expectations tomorrow. With two-year-ahead expectations already elevated at 2.7%, the RBNZ will have little room to absorb upside inflation surprises.

### Click here for:

[Foreign Exchange](#)

- Risk aversion continues to dominate, sending NZD lower.

[Interest Rates](#)

- Rates lower as global concerns continue to dominate.

[Week Ahead](#)

- Inflation Expectations, Trade Balance, Building Consents, Credit Aggregates.

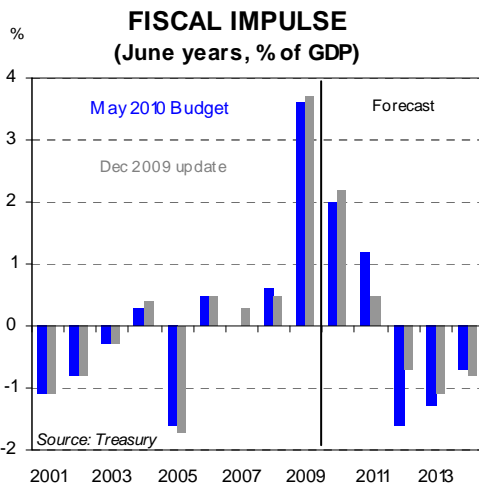
[Week in Review](#)

- Budget 2010 the main focus, net migration, tourist arrival both ease.

[Global Calendars](#)

- UK, US GDP, US housing data, AU Capex, construction work figures due.

### Chart of the week



- In Budget 2010, the outlook for the operating balance deteriorates in June 2011 resulting in a stronger positive 'fiscal impulse' (i.e. the fiscal position is more stimulatory).
- For many months the RBNZ had been very direct in its comments it was looking for more fiscal consolidation in the May 2010 Budget.
- The reason for the more stimulatory fiscal position is that tax changes are likely to take longer to increase revenue than initially estimated. The RBNZ is likely to be accepting of this, given that the overall direction of tax changes will help monetary policy over the longer-term.
- However, in the shorter-term the Budget does put more of the burden on the RBNZ to unwind stimulus in the economy.

### General Advice Warning

As this report was prepared without taking into account your objectives, financial situation or particular needs, you should not take any action in reliance of this report without considering your particular circumstances and, if necessary, obtaining professional advice.

## Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	6 mths ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.6712	0.7059	0.7110	0.7265	0.6146	FLAT	0.6650	0.6950
NZD/AUD	0.8206	0.7978	0.7711	0.7899	0.7890	FLAT	0.7950	0.8200
NZD/JPY	60.34	65.22	66.40	64.58	57.86	FLAT	60.00	63.00
NZD/EUR	0.5372	0.5716	0.5371	0.4862	0.4413	FLAT	0.5250	0.5450
NZD/GBP	0.4653	0.4859	0.4627	0.4395	0.3873	FLAT	0.4550	0.4800
TWI	65.2	67.9	66.4	64.8	58.5	FLAT	64.5	66.5

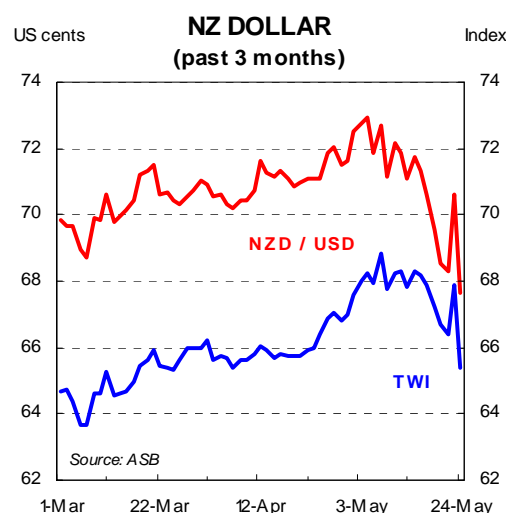
^Weekly support and resistance levels \* Current is as at 1.00pm Monday; week ago as at Monday 5pm

- Risk aversion dominated again last week. The NZD gained on the AUD, but fell noticeably on all the other crosses.
- Financial markets are worried that the euro-zone economy may experience another recession, and that commodity demand will decrease as global growth suffers. This theme is weighing heavily on the AUD and to a lesser extent the NZD. Accordingly, the NZD has made ground on the AUD, with the cross lifting last week.
- Concerns that a forced tightening of fiscal policy in Europe could lead to a 'double dip' recession is boosting demand for US Treasury bonds. As a result, the USD is rising against most currencies. This week will be overflowing with influential US economic data and events. Signs showing the US economy continues to do well compared to Europe is likely to push USD higher.
- Local economic data is likely to be ignored by the currency market in the current environment. Volatility in the AUD and NZD will likely to remain high this week.

### Short-term outlook:

Key data	Date	Time (NZST)	Market expects
RBNZ Q2 Inflation Expectations	25/5	3.00 pm	-
April Trade Balance	27/5	10.45 am	\$455
April Building Consents	28/5	10.45 am	-
April RBNZ Credit Aggregates	28/5	3.00 pm	-
May NBNZ Business Outlook	31/5	3.00 pm	-

**Potential currency movers from offshore this week:** EUR trade balance, US existing home sales (24th); UK GDP, US home prices, consumer confidence (25th); US new home sales, durable goods orders (26th); US GDP, jobless claims (27th); personal income and spending, consumer confidence, Chicago purchasing managers index (28th);. Speeches: Bernanke, Bullard, Plosser (25th); Bullard (27th).



### Medium-term outlook: [\[Last Quarterly Economic Forecasts\]](#)

- In early 2010 the USD did not appreciate as much as we anticipated despite a better performing US economy. Persistently low US bond yields and negative net private sector investment into the US are the main reasons why the USD has not strengthened more.
- In addition, the slowing in Eurozone's economy has not dampened global growth as much as we previously expected. (note this view is in question presently) The slowdown in the Eurozone has been more than offset by a better performing US economy and robust Asian economies. We anticipate further EUR weakness as the economy struggles to gain traction and sovereign debt issues continue to plague investor and business confidence there.
- We now expect the RBNZ to increase the OCR in June and expect the pace of increase to be gradual, reducing the scope for interest rate driven out-performance for the NZD. The NZD is expected to continue to gain on the AUD as the RBNZ lifts rates and interest rate differential with Australia narrows.
- Firm global growth will also work to drive the NZD/AUD exchange rate higher over the remainder of 2010.
- The JPY is expected to slowly weaken this year in response to a stronger USD and a firm global economy.

## Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	6 mths ago	Year ago	ST Bias
Cash rate	2.50	2.50	2.50	2.50	2.50	FLAT
90-day bank bill	2.89	2.91	2.67	2.79	2.78	FLAT
2-year swap	4.33	4.48	4.29	4.44	3.59	DOWN
5-year swap	5.24	5.36	5.26	5.58	4.96	DOWN
5-year benchmark gov't stock	4.92	5.07	5.21	5.38	4.60	DOWN
NZSX 50	3051	3171	3302	3113	2763	DOWN

\* Current is as at 1.00 pm Monday; week ago as at Monday 5pm. Please note that we have recently changed the NZ govt 5-year benchmark bond to April 2015 maturity (from April 2013). This does cause some distortion in the comparison against the previous levels (i.e. month ago).

- Global interest rate markets continued to rally (yields lower), as the escalation of market concerns regarding the European sovereign debt crisis drove “flight to safety” flows. In particular, the decline in government bond yields has been dramatic (see chart below). Over March and April, US 10-year Treasury bond yields had finally recovered to trade near 4%, which is the lower end of what we consider a ‘normal’ range. However, over the last week, US 10-year bond yields dropped from around 3.55% to around 3.2% - back towards financial crisis levels.
- In addition to market concerns around Europe, there is early evidence of liquidity coming under renewed pressure. This is reflected in the widening spread between US LIBOR rates and expectations for the Fed Funds Rate.
- There are concerns that liquidity/funding problems may spread to NZ and see the RBNZ hold off raising the OCR in June. Reflecting these concerns, the 1-year swap rate has plunged. The market currently has only 40% of a rate hike priced in.

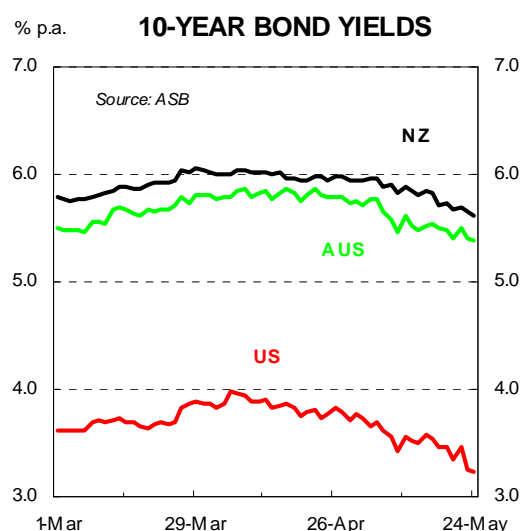
### Short-term outlook:

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**Comment:** Markets remain jittery, as concerns about European debt contagion continue to weigh on sentiment. Offshore events will continue to dominate and local markets are likely to continue to look through this week’s local data. Nonetheless, inflation expectations in particular will be interesting given the deteriorating inflation outlook over the next year. Further yield curve flattening is likely to be the direction of markets this week.

### Medium term outlook: [Last Quarterly Economic Forecasts](#)

- The RBNZ held the cash rate at 2.5% at the April OCR Review, and indicated monetary policy tightening will commence “over the coming months”.
- The RBNZ left its near-term projection for the 90-day interest rate unchanged at the March MPS, but there was a downward revision in its medium-term 90-day track in recognition that current bank funding costs were likely to persist. This supports our expectation that OCR increases will be in 25 basis point increments over the tightening cycle this year. Furthermore, in a recent speech Governor Bollard validated the current market pricing, which assumed a similar profile for rate hikes.
- Inflation in the here and now has remained subdued, allowing the RBNZ some breathing room to assess recent trends. However, we expect inflation to lift to almost 6% over the next year, with a host of upcoming administrative inflation (including GST) boosting headline CPI, and thus posing a risk to price and wage setting behaviour.
- Activity data has been mixed. The external outlook remains upbeat, with commodity prices strengthening. However, retail sales have been surprisingly subdued and the RBNZ remains concerned about the weakness in business credit demand. Nonetheless, the unequivocal strength in Q1 employment data should alleviate the RBNZ concerns on the underlying strength in the domestic recovery.
- The RBNZ expects to begin removing monetary stimulus in “coming months” assuming the economy evolves as expected. We now expect the first rate hike in June, barring a substantial deterioration in liquidity triggered by the European sovereign debt crisis.



## NZ Data Preview: a look at the week ahead

Data	Date	Time (NZST)	Previous	Market expects	ASB expects
Q2 RBNZ Inflation Expectations – 2 year ahead	25/5	3.00pm	2.7%	-	-
April Trade Balance – monthly balance	27/5	10.45am	567m	-	450m
April Building Consent Issuance – ex-dwelling mom	28/5	10.45am	-8.4%	-	-
April RBNZ Credit Aggregates – business yoy	28/5	3.00pm	-8.2%	-	-
May National Bank Business Outlook	31/5	3.00pm	49.5	-	-

### Tuesday 25 May

#### Q2 RBNZ Inflation Expectations

**Previous: 2 year ahead expectations 2.7%**

While annual headline CPI inflation is currently at the middle of the target band, the elevated level of 2 year ahead inflation expectations will be of some concern for the RBNZ. There will be much interest in whether inflation expectations remained high in the June quarter.

A host of administrative inflation - including the implementation of Emissions Trading Scheme and increase in GST to 15% - over the coming year will likely push annual headline CPI close to 6% next year. The RBNZ has noted it will look through the first round effects of these government charges. While the June survey result is unlikely to take into account any of this administrative inflation, future inflation expectations results will provide important insight into whether the RBNZ's assumption that inflation expectations will remain anchored holds.

### Thursday 27 May

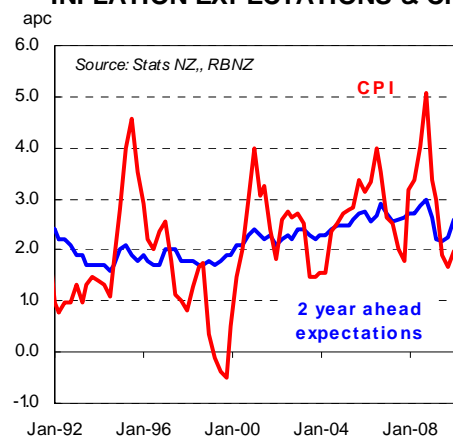
#### NZ April Trade Balance

**Previous: \$567m, ASB f/c: \$450m**

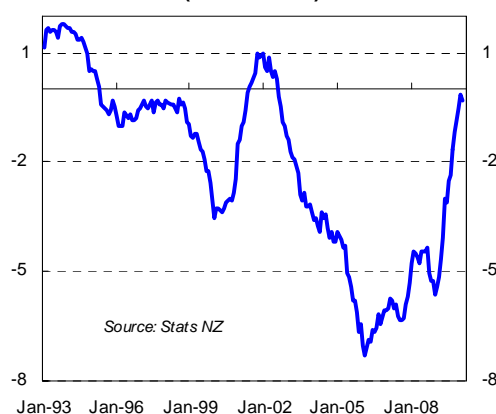
We expect a trade surplus of \$450 million in April. The trade balance tends to be stronger over the first half of the year, as agricultural exports reach the seasonal peak.

Export receipts continue to fare well through the peak agricultural season. In particular dairy receipts continue to hold up despite the drought affecting production in the top of the North Island. Dairy prices continue to improve as global supply remains tight, particularly in recent months. Meat exports values are also performing well, although prices received are disappointing. Import demand continues to gradually recover.

#### INFLATION EXPECTATIONS & CPI



#### NZ GOODS TRADE BALANCE (annual total) \$b



**Friday 28 May**

**NZ April Building Consent Issuance**

**Previous: Core issuance -8.4% MoM**

Total building consents were reasonably stable in March, but once excluding the volatile apartment component core consents fell 8.4%. It appears the slowdown observed in the property market over recent months may be holding back building intentions. Uncertainty over the taxation of property has been contributing to a soft 2010 housing market, and in turn, weak building intentions.

Non-residential consent issuance has been muted so far for 2010, and consents for the three months to March are down 18% on year-ago levels.

We expect overall building activity will pick up over 2010, having been in retreat for much of the preceding 2 years as housing construction shrank. We expect housing construction will recover to a degree over 2010 and provide a boost to GDP growth. However, the modest level of consent issuance has raised a question mark over the strength of this recovery.

**Friday 28 May**

**April RBNZ Credit Aggregates**

**Previous: Housing +3.3% yoy, Business -8.2% yoy**

Household credit growth remains very subdued, reflecting weak retail spending and slowing housing market activity. A large degree of caution remains within the household sector, given weak wage growth.

Business credit remains very weak, with lending down on year-ago levels. The RBNZ has noted in its recent communications of its desire to see a recovery in credit demand in order to support a gradual recovery in business investment activity.

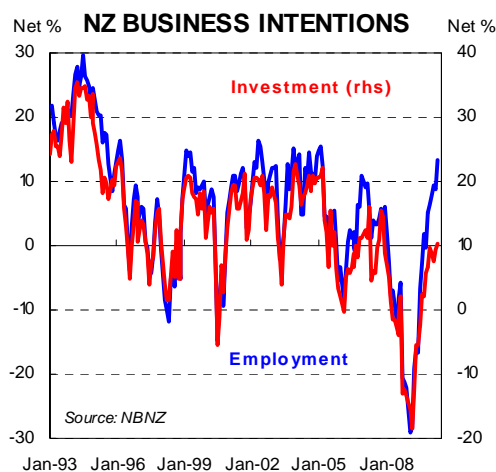
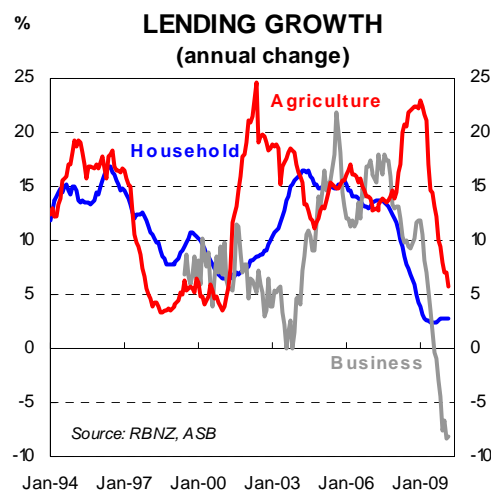
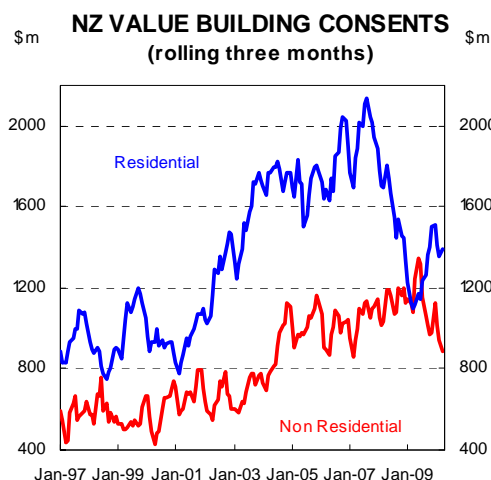
**Monday 31 May**

**May National Bank Business Outlook**

**Previous: Headline 49.5, Own Activity 43.0**

There has a substantial improvement in business sentiment over the past year. In particular, improving demand has encouraged businesses to plan for an expansion of operations. We have begun to see tentative signs of this improvement in investment in hiring and investment intentions flow through to real activity.

Given the continued improvement in the growth outlook of our trading partners, we expect the rebound in export demand will continue to underpin business confidence. Of some concern has been subdued consumer spending. While recent retail sales data showed continued weakness in spending, the rebound in the outlook in the retail sector suggests that retailers see some improvement over the coming year. Overall, we expect business sentiment to remain at current high levels, and businesses will continue to expand their operations over the coming year.



## NZ Data Review: weekly recap

### Budget 2010

The focus of this year's Budget is on reforming the tax system, with the aim of reducing the distortions which have been affecting work and investment decisions. As a result, the key changes to the Budget are the reduction of income tax across the board, increase in GST to 15% and the removal of the ability to claim depreciation on many buildings (including rental houses and offices).

The deterioration in the near-term fiscal deficit outlook sees the deficit increasing to 4.2% of GDP in the June 2011 year from 3.7% GDP (June 2010). The combination of the deferral of large expenses, the increased costs associated with policy changes as well as slower than expected revenue growth adds up to a cash squeeze in the June 2011 year. From this point on the outlook for fiscal deficits improves swiftly. Most of this improvement can be attributed to the better economic outlook.

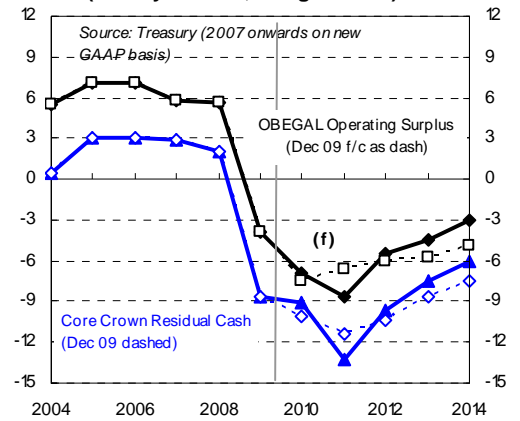
### April International Travel and Migration

Short-term arrivals fell 1.8% in April. On the surface, it's possible to interpret the April decline in short-term visitor arrivals as due to the air-travel disruption caused by the eruption of the Icelandic volcano closing airspace over Europe. However, looking more closely at the flows, the fall in arrivals was across a number of countries.

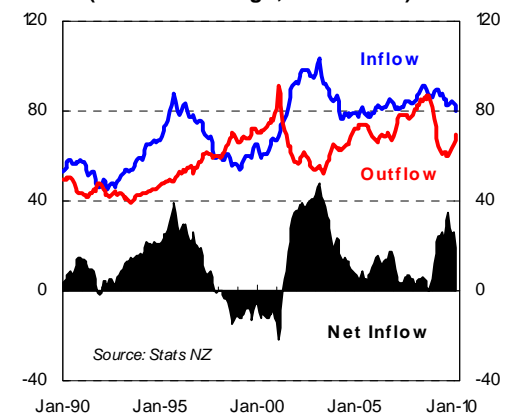
Looking beyond the monthly volatility, the trend in visitor arrivals has been improving. While growth in Australian visitor numbers has stalled, there appears to be a recovery in arrivals from Asia.

Net migration softened further in April, with just a 770 net increase recorded over the month and 19,954 net arrivals over the year to April. This is down from a peak of 22,600 in January. We expect the annual inflow of net migrants to continue to slow, as departures begin to recover (particularly to Australia). Stronger employment growth and a firmer labour market in Australia, relative to NZ, will continue to attract New Zealanders across the Tasman over the next year.

**NZ KEY FISCAL BALANCES**  
(June years \$b, Budget 2010)



**NZ MIGRATION**  
(3-month average, annualised)



## Global Data Calendars

Note: Calendar 2 is in UK times. Add 11 hours for NZ times.

### Calendar - Australasia, Japan and China

Date	Time		Econ Event	Period	Unit	Forecast		
	NZT					Last	Market	ASB/CBA
Mon 24 May	~	JP	Cabinet office monthly economic report					
	13.30	AU	New motor vehicle sales	Apr	m%ch y%ch	-2.7 19.2	~ ~	10.0 ~
	16.30	JP	All industry activity index	Mar	m%ch	-2.3	~	~
Tue 25 May	15.00	NZ	RBNZ 2yr inflation expectation	QII	%	2.7	~	~
Wed 26 May	11.50	JP	BoJ monetary policy meeting minutes for April	May	~	~	~	~
	12.30	AU	Westpac leading index	Mar	m%ch	0.5	~	~
	13.30	AU	Construction work done	QI	q%ch	2.6	~	~
	17.00	JP	Small business confidence	May	Index	46.8	~	~
Thu 27 May	11.50	JP	Merchandise trade balance	Apr	¥bn	666.2	~	~
	10.45	NZ	Trade balance	Apr	NZ\$m	567.0	~	~
	10.45	NZ	Imports	Apr	NZ\$bn	3.5	~	~
	10.45	NZ	Exports	Apr	NZ\$bn	4.1	~	~
	10.45	NZ	NZ trade balance 12 mth	Apr	ytd	-194.0	~	450.0
Fri 28 May	10.45	NZ	Building permits	Apr	m%ch	-0.4	~	~
	11.30	JP	Overall household spending	Apr	m%ch	4.4	~	~
	11.30	JP	Jobless rate	Apr	%	5.0	5.0	~
	11.30	JP	Job-to-applicant ratio	Apr	ratio	0.49	0.51	~
	11.30	JP	National CPI	May	y%ch	-1.1	-1.0	~
	11.30	JP	National CPI ex-fresh food	May	y%ch	-1.2	-1.4	~
	11.30	JP	National CPI ex food, energy	May	y%ch	-1.1	~	~
	11.50	JP	Retail trade	Apr	m%ch y%ch	0.8 4.7	~ ~	~ ~
	13.30	AU	Private capital expenditure	QI	q%ch	5.5	~	0.0

## Calendar – North America & Europe

Please note all days and times are UK time, not local release day/times

Date	UK			Period	Unit	Last	Forecast	
	Time	Econ	Event				Market	CBA
Mon 24 May	13.30	US	Chicago Fed national activity index	Apr	Index	-0.1	~	~
	15.00	US	Existing home sales	Apr	m%ch	6.8	4.7	~
Tue 25 May	09.30	UK	GDP	Q1	q%ch	0.2	~	~
					y%ch	-0.3	~	~
	10.00	EZ	Industrial new orders	Mar	m%ch	1.8	1.5	~
					y%ch	12.4	12.2	~
	14.00	US	S&P/CS composite-20	Mar	y%ch	0.6	~	~
	15.00	US	Richmond Fed manufacturing. index	May	Index	30.0	25.0	~
Wed 26 May	15.00	US	Consumer confidence	May	Index	57.9	58.8	~
	13.30	US	Durable goods orders	Apr	m%ch	-0.6	1.5	~
	13.30	US	Durables ex transportation	Apr	m%ch	3.5	0.3	~
	14.00	CA	Canada house price index	Apr	y%ch	9.9	~	~
Thu 27 May	15.00	US	New home sales	Apr	m%ch	26.9	2.2	~
	~	GE	CPI - EU harmonised	May	m%ch	-0.1	~	~
					y%ch	1.0	~	~
	13.30	US	GDP (annualized)	Q1	q%ch	3.2	3.4	~
	13.30	US	Personal consumption	Q1	q%ch	3.6	~	~
	13.30	US	GDP price index	Q1	q%ch	0.9	0.9	~
	13.30	US	Core PCE	Q1	q%ch	0.6	~	~
Fri 28 May	13.30	US	Initial jobless and continuing claims	May	~	~	~	~
	00.01	UK	GfK consumer confidence survey	May	Index	-16.0	~	~
	13.30	CA	Current account (BOP)	Q1	\$bn	-9.8	~	~
	13.30	US	Personal income	Apr	m%ch	30.0	50.0	~
	13.30	US	Personal spending	Apr	m%ch	0.6	0.3	~
	13.30	US	PCE deflator	Apr	y%ch	2.0	~	~
	13.30	US	PCE core	Apr	m%ch	0.1	0.1	~
					y%ch	1.3	~	~
14.45	US	Chicago purchasing manager	May	Index	63.8	62.4	~	
14.55	US	University of Michigan Confidence	May	Index	73.3	73.4	~	

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