

# BNZ Weekly Overview

26 August 2010

## Mission Statement

To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

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The Weekly Overview is written by Tony Alexander. The views expressed are my own and do not purport to represent the views of the BNZ. To receive the Weekly Overview each Thursday night email me at [tony.alexander@bnz.co.nz](mailto:tony.alexander@bnz.co.nz) with 'Subscribe' in the Subject line.

## The World Remains A Challenging Place

Fresh economic data releases have been thin on the ground in New Zealand this week, but offshore it has been a different story. In Europe we have seen a lift in German business confidence to a three year high coming hard on the heels of an earlier report showing 2.2% growth in the German economy during the June quarter. But while this augurs well for the Euro area's short term economic prospects there are rapidly growing concerns about the ability of high budget deficit countries to continue their fiscal austerity programmes as their economies shrink and unemployment heads skyward.

This growing concern about Europe's finances has led to a fresh blow-out in the premium which indebted governments must pay to raise debt from investors. In Greece the cost of borrowing measured as a margin above German bond yields has risen back to over 9% and sits just 0.5% below the peak margin reached during the depths of the fiscal crisis early this year. Standard and Poors have cut the credit rating of Ireland, and commentary is becoming more and more conspicuous regarding probable default/debt restructuring.

In other words, the glass half full interpretation being given to the European debt situation is in the process of evaporating and changing back to glass half empty.

In the United States talk is less about government debt problems (that issue lies further down the track there) and more about the economy's inability to sustain the recovery which so far has been driven by a low greenback boosting exports plus special fiscal and monetary stimulus measures. Two weeks ago the Federal Reserve reacted to the reducing prospects of growth continuing by loosening its quantitative monetary policy a tad more. This week data have appeared showing that the ending of a special tax credit for house purchases has produced a plunge in house sales at the same time as indicators for the manufacturing sector and labour market have turned out to be weaker than expected.

For New Zealand the relevance of this growing concern about global growth is reductions in long term borrowing costs which have led to cuts in bank fixed housing interest rates with probably more to come in the near future. Prospects for the pace of NZ monetary policy tightening have also changed with the RBNZ now more and more likely to take a decent pause after only two cash rate increases.

The Kiwi dollar has weakened below the US 70 cent level as investors have pulled their funds away from volatile risky assets like our far flung currency. This move lower will be welcomed by exporters but they should remember that because the driving force in the currency's decline is world growth worries the downside will be reduced demand for exports all up.

With regard to food exports however the picture is a tad more mixed because of rising global concern about food availability and cost following the drought in Russia and floods elsewhere cutting grain production. This probably explains why after announcing they would announce a review of the milk solids payout Fonterra made the announcement last week of no change!

Of course these sort of things are the obvious economic ones we have seen before and there are natural equilibrating movements in interest rates and exchange rates which help insulate our economy from the turbulence offshore. But a key factor we need to keep an eye on is the one which would have sent us into a Depression scenario in 2008-09 if things had not eased up and which was becoming a concern again a few months ago when worries about Europe were at their peak – ability of NZ banks to raise funds offshore.

We banks have to raise about 40% of the funds we lend out in New Zealand from investors offshore. As worries about Europe and the world economy grow again the cost of raising these funds will go up – thus offsetting some of the falls in wholesale funding costs which have allowed fixed interest rates to decline. In addition our ability to raise long term funds will once again become compromised.

None of this yet adds up to anything approaching the late-2008 situation and we remain of the firm opinion that the economies of our trading partners and our own economy will continue to grow at acceptable paces on average next year. But two years down the track from the collapse of the Lehman Brothers investment bank the world remains a still very uncertain place with a few bad things like European debt default still quite likely to happen.

That means both householders and businesses are probably doing the exactly the right thing at the moment. Showing above average confidence regarding the economy in the coming year (evident in practically every survey available) but nonetheless guarding their cash tightly and focussing more on getting debt down than gearing up for a bright economic future which frankly may not appear until this current impossible to predict cycle has run its course and we get set for the next one further down the track.

## INTEREST RATES

Two weeks ago the Reserve Bank Governor gave a speech in which he expressed greater concern about the pace of recovery in the economy so far and indicated clearly that he is in no hurry to raise interest rates. In light of those comments plus economic data recently released here and overseas we have decided to change our forecast track for increases in the official cash rate. We now think the RB will leave the rate at the current 3% until December when rises will get going again supported by our expectation that growth in the economy will slowly become more broadly based and a few more borrowers will come out of the woodwork.

But we retain the same warning we have had for many many months now. No-one on the planet has a reliable model which tells us what is likely to happen with business and consumer willingness to spend, borrow, hire etc. and their tolerance of interest rates and desire to get debt down coming out of a near depression scenario. We are two years down the track from the Lehman Brothers bank collapse and the onset of Depression fears and still there is a lot unknown around the world.

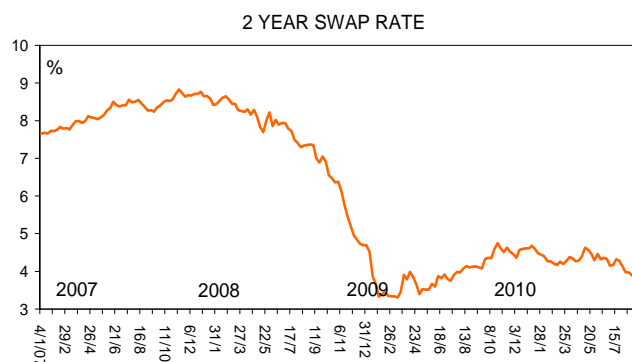
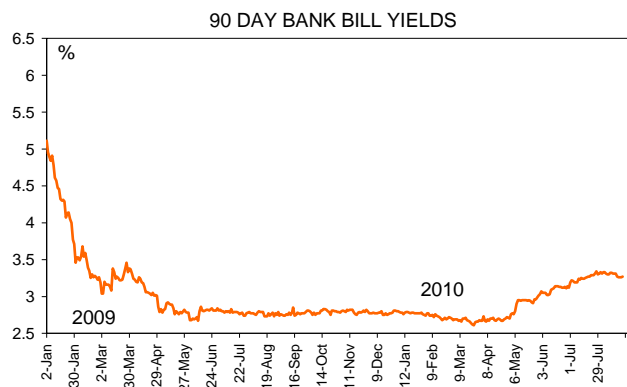
For us here in particular over the next two years we are going to gain some insight into the extent to which us debt-loving Kiwis have become more interest rate sensitive. As we have noted many times over the years there is something weird about us New Zealanders in that we will pay much higher interest rates to borrow money than people offshore. No obvious answer jumps out in front of us to explain this and certainly the old one about people remembering much higher interest rates in the past becomes irrelevant when we consider that perpetually high rates disappeared a generation ago.

Based on what we expect now floating wholesale and retail borrowing costs are likely to remain at current levels through into December while fixed rates will also remain low. Note however that these latter rates are more heavily affected by events offshore than floating rates which are mainly affected by changes in the

## BNZ WEEKLY OVERVIEW

official cash rate. That means that if things look better overseas we could get a quick jump up in fixed rates, while if they look worse these rates will go down.

This week we have seen 90-day bank bills end near 3.26% from about 3.3% last week while swap rates have edged lower yet again. The two year swap rate has finished near 3.79% from 3.9% and the five year rate near 4.25% from 4.4%.



### Key Forecasts

- Tightening through to mid-2012 with the next rate rise on December 9.

#### FINANCIAL MARKETS DATA

	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	3.00%	3.00	2.50	2.50	2.50	5.9
90-day bank bill	3.26%	3.26	3.29	2.96	2.73	6.2
1 year swap	3.52%	3.58	3.75	3.64	3.19	6.3
5 year swap	4.25%	4.44	4.76	5.25	5.44	6.6
180-day term depo	4.10%*	4.10	4.80	4.90	3.15	6.0
Five year term depo	6.50%	6.75	6.75	6.75	6.00	6.5

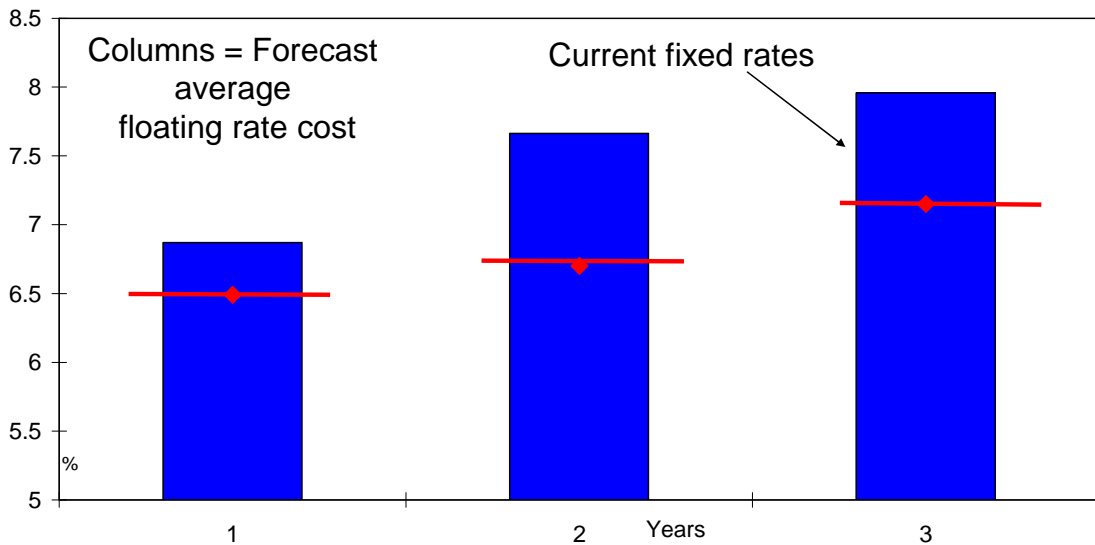
\* 150 days = 5.1%

### If I Were a Borrower What Would I Do?

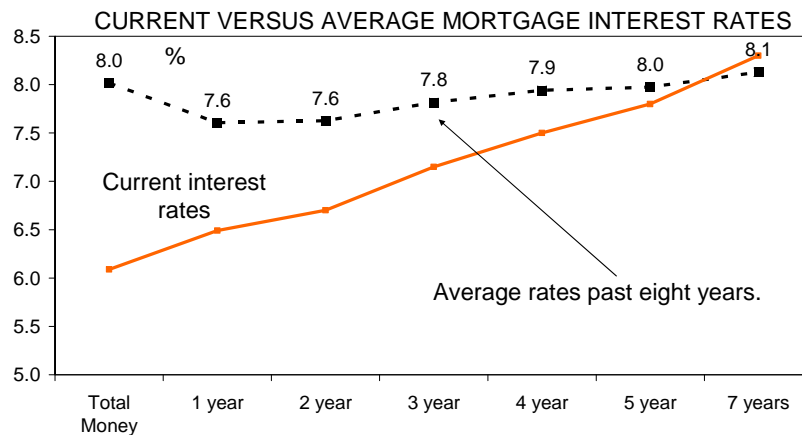
Things have changed enough here and overseas that we feel the Reserve Bank will now not raise the official cash rate again until December. That means steady floating rates until then and little reason for jumping into a fixed rate unless one expects the fixed rates to suddenly rise. So if you are a conservative person you might put some of your mortgage at a two year rate simply for safety as we noted last week. But practically everyone will probably be best served by staying on the floating rate many have been on since the middle of last year and waiting until we get some greater clarity about where things are going. Note that given the way swap rates have decreased yet again this week we could see some further falls in bank fixed interest rates.

With regard to the graph below, what it shows is the following. The blue bars are what we think the floating rate will average over the coming year. For the next year that is 6.9% which compares with the current one year floating rate of 6.7%. It is cheaper to fix than float. The forecast floating rate for the next two years is 7.7% versus the two year fixed rate currently at 6.7%. A person will save about 1% fixing rather than floating. The forecast floating rate for the next three years is 8% which compares with a three year fixed rate of 7.15%. it is again cheaper to fix than float.

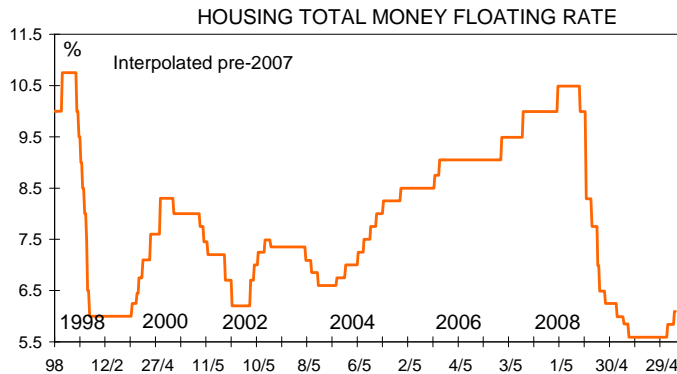
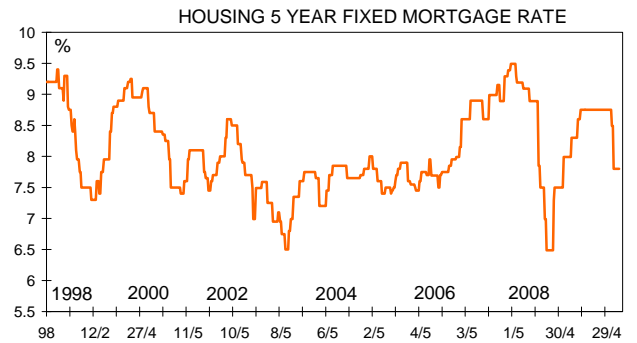
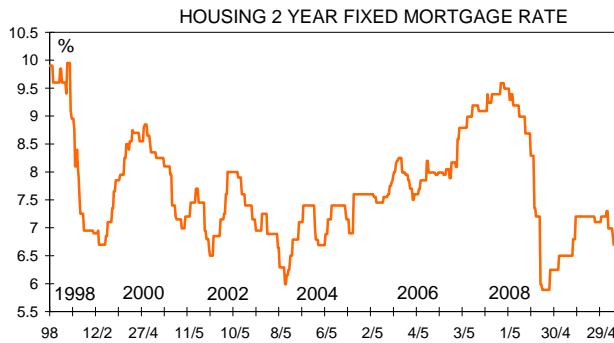
But as noted above, borrowers probably still have time on their side to float before jumping into fixed. Late last year we picked the point for sacrificing low floating to secure a low fixed rate before it jumped up to be in the period from May into July. Now it looks like that period will come much later this year. Floating therefore remains optimal for all but the most conservative. But be aware of one important thing.



As each week goes by more and more people have their fixed rate mature and they go floating. Some will plan to stay floating through the cycle. But others will be floating simply as they wait for the optimal time to fix. That means that if conditions appear again as they did in March last year when billions of dollars of loans were suddenly switched from floating to fixed we will again see a severe jump up in fixed rates. We seem to be many months away from that point however.

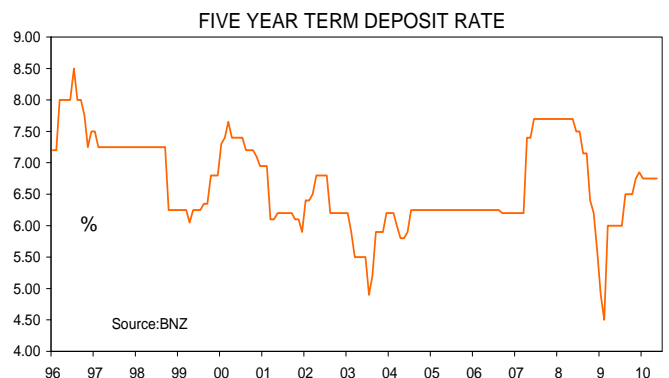
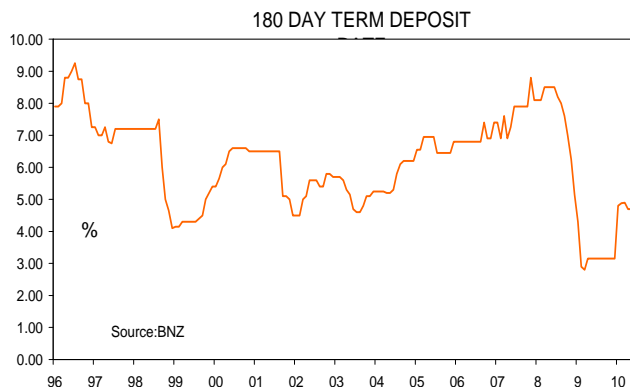


This week someone asked the logical question about why we use an eight year average and not something else. There is no great science involved I am afraid. First, using ten years the averages are all the same except the floating rate is 0.2% lower and the one year fixed rate 0.1% higher. If we use five years all averages are 0.3% higher. But that period is catching too much of the time when the RB was fighting hard against our high borrowing and the official cash rate was between 6.75% in September 2005 and 8.25% in June 2008. None of us are forecasting the OCR ever getting back to that level so it is best to water down its effect by also capturing the period before 2005.



**If I Were a Term Deposit Investor What Would I Do?**

Nothing new. I would have most short term but some toward five years to improve the average yield.



**HOUSING MARKET UPDATE**

**Nothing New**

Just a quick comment here regarding commentary on the housing market in particular, but pretty much anything else. If you go on the internet you will find exactly the same type of commentary as you would find on a slow Friday night in the local pub. People who know a little bit about something attempting to develop a view on what is happening overall based upon what they see around them. Their information is very limited, their understanding of the broad forces which drive markets over the medium to long term woefully inadequate, and their conclusions invariably extremist.

In particular, what the average Joe Bloe commentator does is look at the most recent piece of data or anecdote and extrapolate it into a broad trend which will wipe out all other factors and cause either a boom or bust. The problem here is failure to take into account feedback effects, failure to recognise that other

important factors are also in play, and lack of understanding that what drives markets are the averages and not the extremities. And it is often the extremities which one encounters in anecdotes.

More than that one must also be very wary of official data releases. There are not only sampling errors in most surveys, but inherent volatility. Weather changes, sports events and fairly much anything else can cause a bunching of activity normally spread over five weeks into four weeks, or vice versa.

The job of an economist is to look through all the information and see the trends underneath using knowledge of broad relationships between key factors gained through study at university and experience. That is why in this section here on the housing market in particular we don't discuss every single piece of information or anecdote which appears with regard to housing. Most of it is just fluff, one-off surveys with no established record of correlation with market outcomes and outright guesses of what is going on by people who see one small piece of the thing. Think of that latter point in terms of the three blind men each holding a piece of the elephant and trying to describe the nature of the beast in front of them. Each accurately describes what they hold, but wrongly concludes what the total thing is.

There are lots of other mistakes the uninformed in the net writing like they are talking in the pub do – assuming we are the same as overseas and forecasting what happens there will happen here, ignoring structural changes over decades and saying stuff now will revert to where it was decades ago when they were in their teens, and believing valuation measures in particular tell you where markets will go. Wrong. They simply show where you sit compared with where you have sat on average in the past – when things were quite different from where they are now.

Anyway, enough written. The upshot of this short commentary is that in this section we only put stuff in which we think is relevant, we don't take every fresh piece of news as indicating things are shooting wildly up or down, and we don't for a second think we have our hands on the entire elephant. There are always unknown bits out there which justify caution in making an assessment about what is really there and going on.

### Old Folk

Following on from our comments last week regarding old folk wanting to stay in their family homes here are some observations made by a Kiwi in Vienna.

"I read with interest your comment that older people are not down-sizing their homes and are remaining in houses bigger than they need. From time to time I conduct pre-retirement seminars and for the last 10 years I have become aware that what economists and financial advisors believe people need is in conflict with the psychological needs of retirees. I, as a psychologist, suggest that people will not downsize their housing because the need in retirement is for more space not less. It is only when one person in a relationship dies will the need for a smaller house/Apartment occur. The reasons:

On retirement married/partnership couples find that they for the first time are spending more time together as a result for the relationship to work they need more space. For retired international civil servants (pension is usually around US\$50,000 per year) it seems the following is needed:

Three bedrooms: Two separate work rooms/offices, Two Telephones. The simple fact is in retirement couples need more space to give each other healthy levels of privacy and ensure they are not in each others' face all day."

### Are You Seeing Something We Are Not?

If so, email us at [tony.alexander@bnz.co.nz](mailto:tony.alexander@bnz.co.nz) with Housing Comment in the Subject line and let us know.

#### Key Forecasts

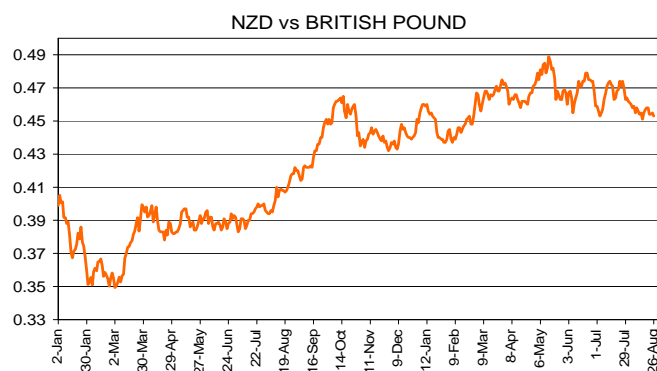
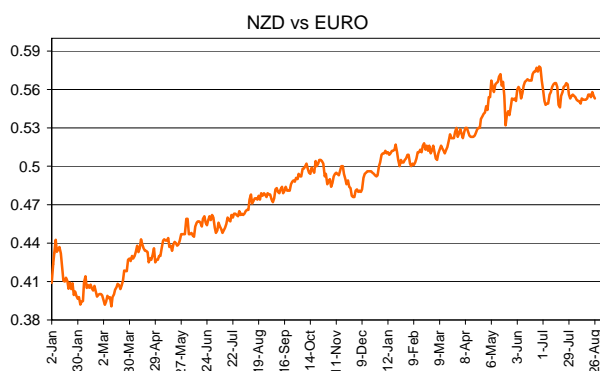
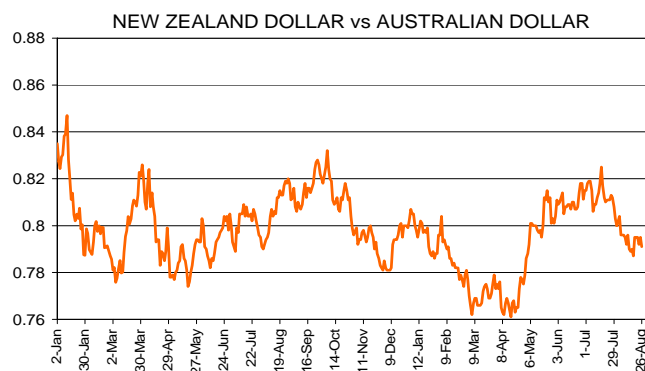
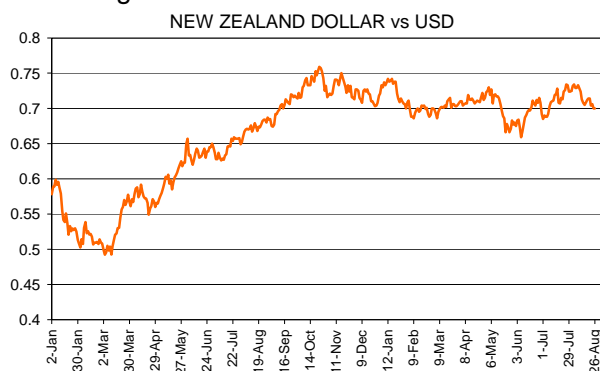
- Dwelling consent numbers to recover now with potentially good activity from mid-2011. (Changed from late-2010 August 26).
- House prices edging higher from second half of 2011. (Changed from post-Budget August 26)

## Exchange Rates & Foreign Economies

Exchange Rates	This Week	Week Ago	4 wks ago	3 mths ago	Yr ago	Consensus Frcsts yr ago*	10 yr average
NZD/USD	0.704	0.714	0.726	0.666	0.684	0.610	0.592
NZD/AUD	0.793	0.795	0.811	0.812	0.818	0.770	0.856
NZD/JPY	59.60	61.00	63.60	60.00	64.4	61.366	66.8
NZD/GBP	0.452	0.458	0.471	0.463	0.418	0.380	0.345
NZD/EUR	0.553	0.556	0.563	0.540	0.478	0.445	0.51
USD/JPY	84.66	85.43	87.60	90.09	94.15	100.600	113.9
USD/GBP	1.558	1.559	1.541	1.438	1.636	1.607	1.709
USD/EUR	1.273	1.284	1.290	1.233	1.431	1.372	1.156
AUD/USD	0.888	0.898	0.895	0.820	0.836	0.792	0.69

### Kiwi Pushed Lower

The Kiwi dollar has fallen back close to the US 70 cent level this week on the back of yet another bout of heebie geebies gripping world financial markets causing selling of both growth and risky assets. This afternoon we are sitting near the 70.4 cent level while against the Aussie dollar the Kiwi is close to 79 cents from 79.5 last week. Against the Japanese yen we have fallen to a 13 month low just under 60 from 61 last week while against the British Pound we are near 45.2 pence from 45.8 last week. Against the Euro we are little changed near 55.3 centimes.



Two key areas of concern occupy the minds of investors at the moment. The first is the release in recent weeks of weaker than expected economic data in the United States. For instance just this week we have seen a surprising jump in the number of people claiming the unemployment insurance benefit, a weak reading in one of the sub-national manufacturing gauges, a 27% fall in existing home sales in July (-13% expected with the tax credit expiring), a 12% fall in new home sales, and only a 0.3% rise in durable goods orders whereas a gain of 3% had been commonly expected. This latter number worsens to -8% when one excludes defence items and shows that businesses are pulling back on their capital spending plans.

The other area of concern is the ability of highly indebted big deficit European economies to keep selling bonds to increasingly wary investors. In Greece the margin the government must pay to raise debt in the bond market has blown out to the highest level since May measured as a spread over German bond yields. At just over 9% this spread is only 0.5% short of the level reached when European debt worries were at their worst.

This development, along with blowouts in spreads for other governments and a credit downgrading for Ireland, mean at a time when these countries are trying to reduce their deficits their expenses are actually blowing out with regard to debt servicing. Throw in growing discontent by voters with the extreme pace of fiscal tightening and one gets an environment where it seems just a matter of time before an official debt restructuring is announced for Greece with the possibility of other big debtor economies also seeking some repayment relief.

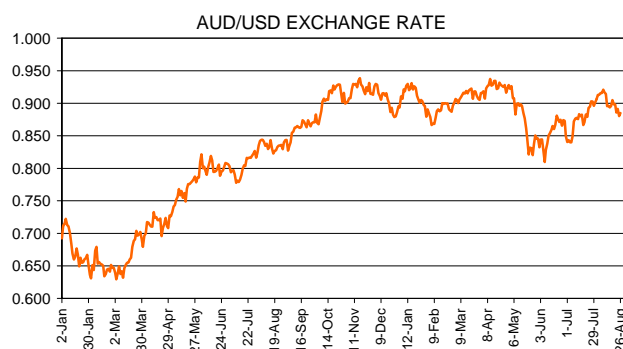
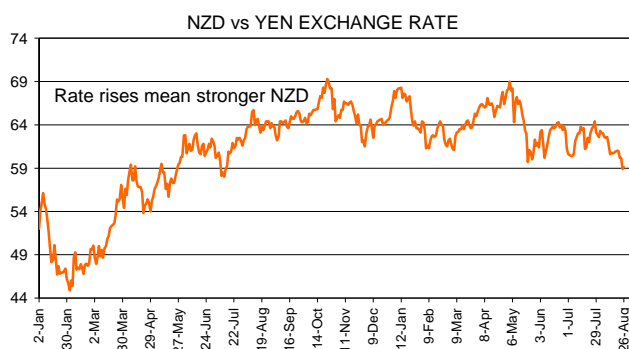
Investors have been reacting to their worries by selling USDs because of US growth fears, selling Euro because of debt fears outweighing positive economic data, and buying Swiss Francs and Japanese yen. The Swiss Franc has reached a record high against the USD and the Yen a 15 year high. This latter movement has however generated extreme concern in Japan where exports are still relied upon to drive growth in a country where consumers have shown for the past two decades that they are going to spend very little.

As yet there has been no official intervention by the Japanese authorities to weaken the Yen but it seems just a matter of time before this happens.

Thus there are some extremely strong and unpredictable factors in play driving the major currencies and it is unlikely this situation will change for a very long time. Currency predictability is therefore even less than the usual very low level and Kiwi companies looking at their currency exposures should take this high uncertainty into account when determining their optimal hedging strategies.

For the moment our expectation is that world worries are likely to drive the Kiwi dollar lower.

Briefly, across the ditch uncertainty about what form the next government will take caused the AUD to drop a cent on Monday. But since then little has happened and the AUD is now near US88.5 cents from near 90 cents last week.



For more detailed commentaries from BNZ and the NAB group on foreign currencies, commodities, etc click on the following link.

<https://research.bnz.co.nz/Research/Pages/default.aspx>

\*Sourced from Consensus Economics. <http://www.consensuseconomics.com/>

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## ECONOMIC DATA

All %		Latest qtr only	Previous qtr only	Latest year	Year ago	2 Yrs ago
Inflation	RBNZ target is 1% - 3% on average	0.3%	0.4	1.8	1.9	4.0
GDP growth	Average past 10 years = 2.6%	+0.6	0.9	-0.4	-1.4	2.8
Unemployment rate	Average past 10 years = 4.7%	6.8	6.0	.....	5.9	4.0
Jobs growth	Average past 10 years = 2.0%	-0.3	1.0	0.0	-0.9	0.8
Current a/c deficit	Average past 10 years = 5.9% of GDP	2.4	2.9	.....	7.9	7.8
Terms of Trade		5.8	-1.6	-8.2	1.8	8.8
Wages Growth	Stats NZ analytical series	0.4	0.8	2.7	5.4	5.0
Retail Sales ex-auto	Average past 9 years = 3.9%.	1.3	0.7	1.3	-0.6	2.8
House Prices	REINZ Stratified Index	0.7	-1.2	5.1	-5.0	-1.9
Net migration gain	Av. gain past 10 years = 13,900	+15,221	19,954yr	.....	14,488	5,201
Tourism – an. av grth	10 year average growth = 3.2%. Stats NZ	3.8	4.2	3.8	-2.8	0.9
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Consumer conf.	10 year average = 3%. Colmar survey	46	36	57	3	-34
Business activity exps	10 year average = 19%. NBNZ	32	39	39	13	-8
Household debt	10 year average growth = 10.3%. RBNZ	2.5	2.7	2.7	2.6	9.4
Dwelling sales	10 year average growth = 2.5%. REINZ	-26.7	-24.3	-1.1	34.0	-32.6
Floating Mort. Rate	(TotalMoney) 10 year average = 7.9%*	6.09	5.84	5.59	5.85	10.49
3 yr fixed hsg rate	10 year average = 7.8%	7.15	7.30	7.95	7.45	9.09

## ECONOMIC FORECASTS

## Forecasts at July 29 2010

## March Years

## December Years

	2009	2010	2011	2012	2013	2008	2009	2010	2011	2012
<b>GDP - annual average % change</b>										
Private Consumption	-1.1	0.6	2.7	2	1.4	-0.3	-0.5	2.7	2.1	1.6
Government Consumption	4.2	1.4	2.7	1.4	0.9	4.8	1.6	3	1.4	1
Investment	-7.2	-9.5	4.5	5	3.3	-3.6	-12	2.2	5.9	2.9
GNE	-1.5	-3.2	5.2	2.3	1.7	0.4	-5	4.9	2.7	1.7
Exports	-3.4	2.9	2.4	6.4	2.4	-1.4	0	2.8	5.8	3.2
Imports	-4.7	-9.6	9.1	3.3	2.6	1.9	-14.9	9.5	3.6	2.9
GDP	-1.5	-0.4	3.2	3.2	1.6	-0.2	-1.6	2.8	3.4	1.7
Inflation – Consumers Price Index	3	2	4.5	2.8	2.6	3.4	2	4.3	2.7	2.6
Employment	0.7	-0.1	2.4	2.3	0.9	1	-2.4	2.6	2.9	0.8
Unemployment Rate %	5.1	6	5.7	4.9	5	4.6	7.1	6	4.9	5
Wages	5.1	1.6	2	3.6	3.4	5	3.1	1	3.2	3.5

## EXCHANGE RATE

## ASSUMPTIONS

NZD/USD	0.53	0.7	0.72	0.66	0.61	0.56	0.72	0.73	0.68	0.62
USD/JPY	98	91	99	105	105	91	90	97	103	105
EUR/USD	1.31	1.36	1.21	1.25	1.24	1.34	1.46	1.2	1.24	1.28
NZD/AUD	0.8	0.77	0.83	0.84	0.84	0.83	0.79	0.82	0.83	0.83
NZD/GBP	0.37	0.47	0.47	0.4	0.38	0.37	0.44	0.49	0.42	0.38
NZD/EUR	0.41	0.52	0.6	0.53	0.49	0.41	0.49	0.61	0.54	0.48
NZD/YEN	51.8	63.7	71.3	69.3	64.1	50.9	64.2	70.8	69.5	65.1
TWI	53.8	65.1	69.9	65.3	61.6	55.1	64.7	70.5	66.3	61.6
Official Cash Rate	3	2.5	4	5.5	5.25	5	2.5	3.75	5.25	5.5
90 Day Bank Bill Rate	3.24	2.67	4.15	5.65	5.4	5.23	2.78	3.95	5.57	5.65
10 year Govt. Bond	4.77	5.86	6.3	7	7.5	4.88	6.02	5.9	6.8	7.5

All actual data excluding interest & exchange rates sourced from Statistics NZ.

The BNZ Weekly Overview is prepared by Tony Alexander, Chief Economist at the Bank of New Zealand. Ph 04 474-6744.

\*extrapolated back in time as TotalMoney started in 2007