

# BNZ Weekly Overview

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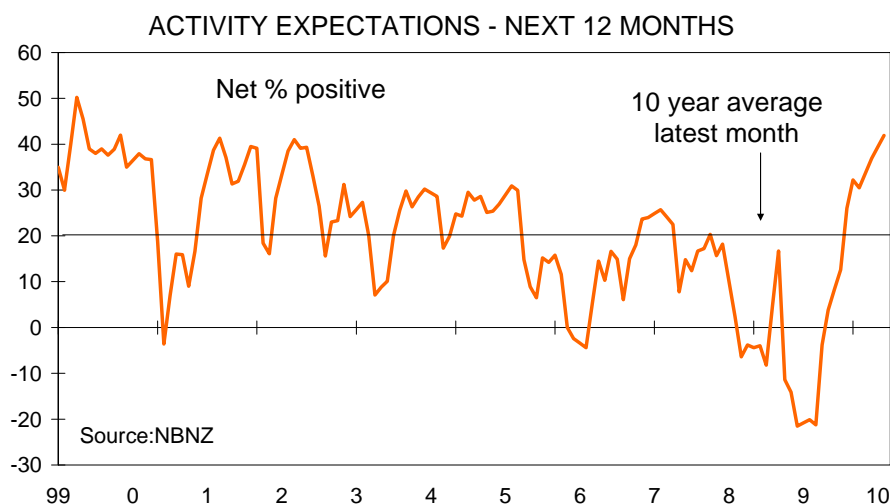
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The Weekly Overview is written by Tony Alexander. The views expressed are my own and do not purport to represent the views of the BNZ. To receive the Weekly Overview each Thursday night email me at [tony.alexander@bnz.co.nz](mailto:tony.alexander@bnz.co.nz)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

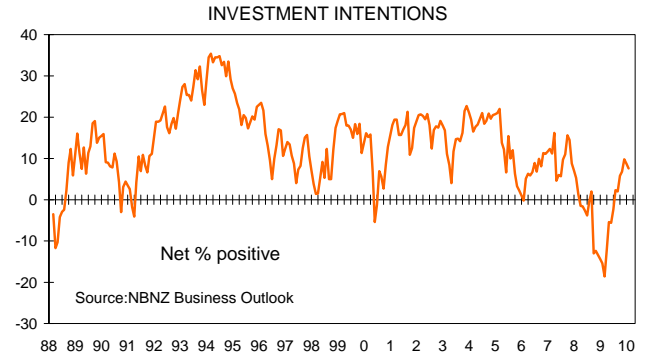
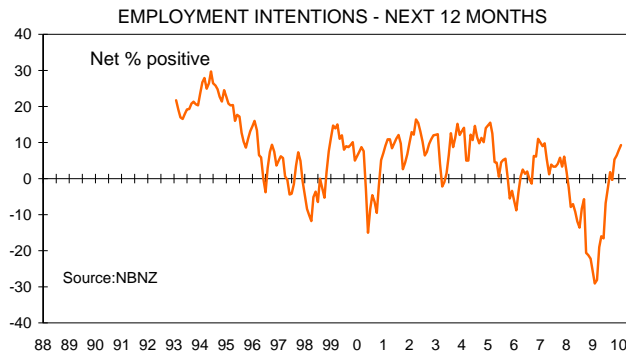
## Businesses Confident

Most of the economic releases recently in New Zealand have been on the not so good side. So it was pleasing today to see something surprising on the strong side – even if it is only attitudes and not actual spending measures. The monthly NBNZ Business Outlook survey showed that business confidence about the economy over the coming year has jumped in February to a decade high of a net 50% positive from the last survey in December where the reading was +39%. A year ago this measure was -41%.

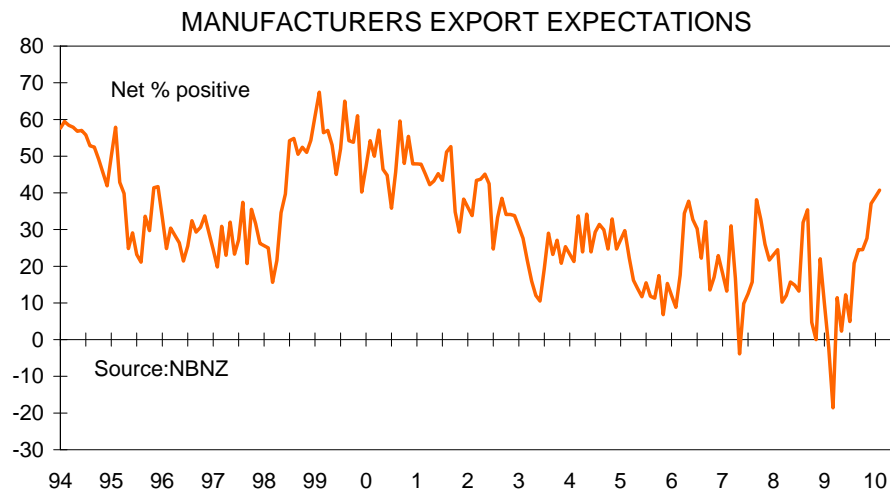
A well above average net 42% of businesses expect their own levels of activity to improve over the coming year and this is up from 37% in December. The average reading is +20% and on the face of it the result would suggest a booming economy as the last time this important measure was this high was back in November 2000 and GDP growth hit almost 5% two years later.



We do not however expect such a strong upturn in the economy this time around even though the subsidiary indicators in the survey are also very positive. A net 9.3% of businesses plan hiring more people. This is up from 6.4% in December and the strongest result since March 2007. The average reading is +3.6%. A net 7.6% plan more investment in plant and equipment. But this is down from 9.8% in December and is below the 10.4% average – though only just.



The results suggest it is reasonable to expect we will soon see some improvement in the labour market and that businesses buy into the upturn scenario. But again we need to emphasise that there is probably an upward bias in the numbers representing a sigh of relief factor with regard to the economy not collapsing. Then again, one may not want to underrate some of the positive developments such as the NZ dollar's fall to its lowest level against the Australian dollar in ten years just above 77 cents. A net 41% of manufacturers expect higher exports over the coming year. This is the strongest result in eight years and bodes well for the manufacturing sector.

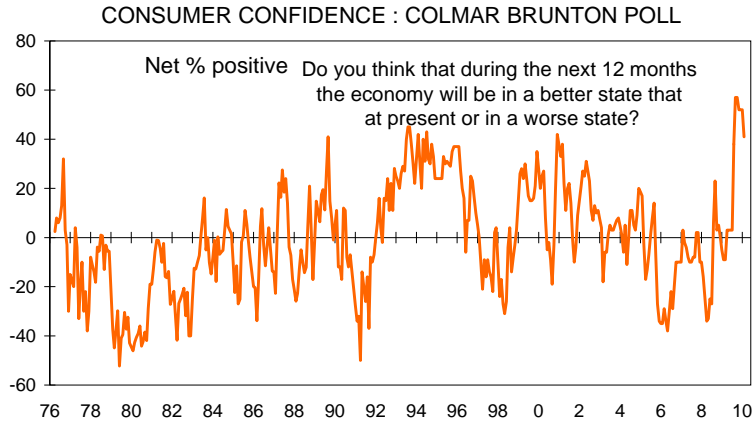


The Reserve Bank will feel justified in continuing their indication of tightening monetary policy in the middle of the year with the net percent of businesses planning to raise their selling prices rising to 26% from 18% in December. This is the highest result since September 2008 just before the Lehman's investment bank collapse. And even though the actual inflation rate is 2% with a 0.2% fall in consumer prices over the December quarter, year ahead inflation expectations are at 2.56%.

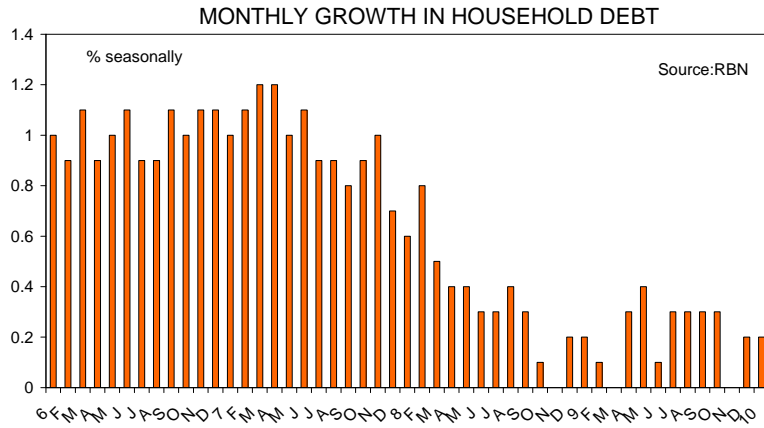
## Consumer Sentiment Eases However

The One News Colmar Brunton poll – which used to be monthly but is now infrequent – recorded a decline in consumer confidence about the economy over the coming year. That doesn't really tell us anything new because other indicators have already pulled back from their high levels toward the latter part of 2009 and this decrease to a net 41% positive from 52% in November seems in line with those other measures.

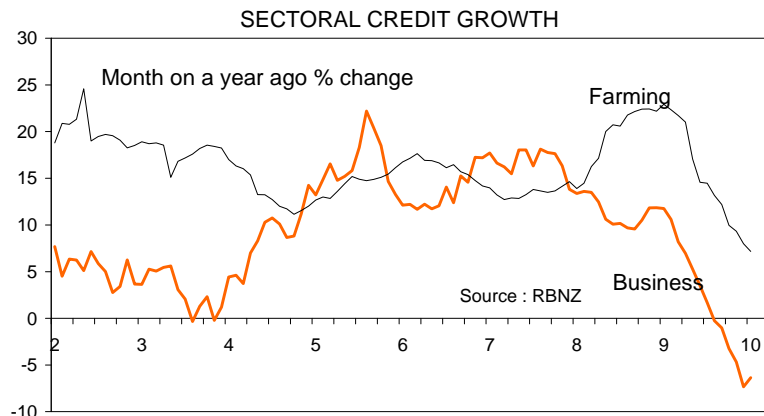
As such our outlook for the area one can most easily extract some relevance from consumer sentiment readings – retailing – remains for improvement but nothing remotely approaching a traditional post-recession boom. The average reading for the poll over the past decade has been a net 3%.



In fact if we were to see a surge in retail spending we would expect by now to be seeing a lift in credit demand. But we are not. In fact household debt grew in seasonally adjusted terms by only 0.2% in January after growing the same in December and not at all in November. The low floating mortgage rates have not produced a surge in borrowing.



Businesses did a bit more borrowing than usual in January with their debt up \$586m whereas it fell \$219m in January 2009 and \$134m in January 2008. These numbers can be exceedingly volatile so we don't read this change as indicating businesses are back out investing heavily again. But hopefully the change means we can start to think in terms of the near average investment intentions revealed in the NBNZ survey above converting into some actual capital spending growth soon. Annual business debt growth is -6.4% from 11.8% a year ago.

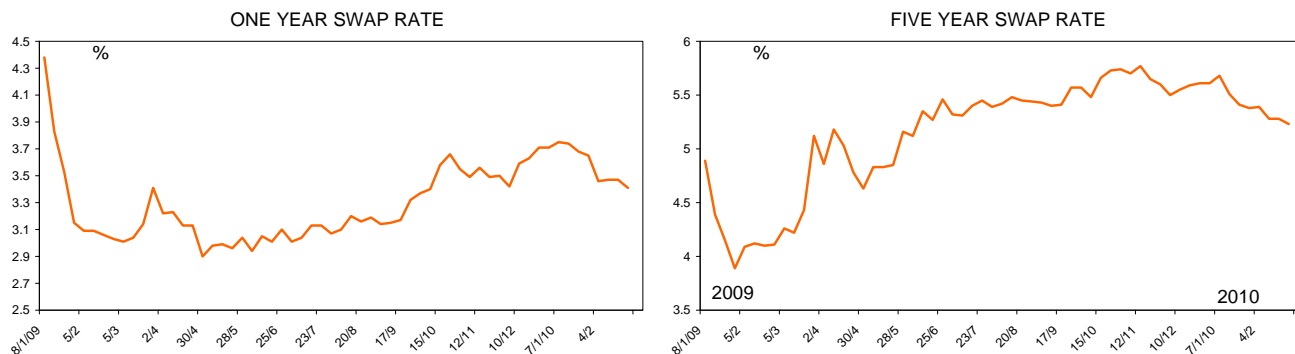


With regard to the farming sector where debt levels are generally considered to be above optimal levels, restraint in borrowing is still evident. Debt grew \$139m in January whereas it rose \$462m in January 2009. Annual farm debt growth has slowed to 7.2% from 22.9% a year ago.

# INTEREST RATES

With worries increasing again overseas about the pace of global recovery there has been a tad more downward pressure on NZ wholesale interest rates this week – though expectations remain strong for the NZ monetary policy tightening cycle to start in June. Once that tightening starts we expect the yield curve to be more moving up and the degree of steepening lessening substantially as long rates will tend to be suppressed by the weak global economy while the rising cash rate influences short rates.

This afternoon 90-day bank bills were unchanged from 2.73% last week but the one year swap rate was near 3.44% from 3.47% and the five year rate 5.23% from 5.28%. That latter rate peaked at 5.77% in the middle of November and has since eased as growth optimism has pared back here and offshore.



## Key Forecasts

- Tightening by mid-2010.
- Medium to long term housing rates to keep on rising.

FINANCIAL MARKETS DATA						
	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	2.50%	2.50	2.50	2.50	3.50	6.2
90-day bank bill	2.73%	2.73	2.80	2.81	3.23	6.5
1 year swap	3.44%	3.47	3.65	3.50	3.03	6.7
5 year swap	5.23%	5.28	5.38	5.60	4.11	7.0

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

If our forecasts for when and by how fast the official cash rate changes prove correct, and there is no change in the relationship between that rate and our Total Money floating rate, then we can forecast average floating rates over one, two and three year periods. For the coming year – if we are accurate – the floating rate will average 6.2%. The current one year fixed housing rate we offer is 6.25%. Therefore one tosses a coin as to fixing or floating for an expected one year exposure.

Over the next two years – if our forecasts prove accurate – the floating rate will average near 7.4%. The current two year fixed housing rate is 7.2%. For an exposure expected to last two years one starts leaning toward fixing.

For the next three years – if our forecasts prove correct – the floating rate will average 8%. The current three year fixed housing rate is 7.95%. Given the hugely uncertain world environment coming out of the worst financial crisis since the 1930s forecasts three years out are understandably dodgy at best. Perhaps worthless.

There is little to be gained at this point from abandoning the floating rate and opting for a fixed rate.

BUT

If wariness about the world economy continues this will tend to suppress the medium to long term funding costs in the next few months before the rate tightening cycle starts in New Zealand. Plus, because the falls in those funding costs in recent weeks have produced healthier fixed rate lending margins, there is a good chance fixed housing rates will not soar as we approach the June policy tightening date.

Therefore, if I were a borrower my strategy becomes this. Enjoying a 5.59% floating rate is wonderful and I can get my principal down a lot by keeping repayments where they were previously when the rate was fixed at a higher level. Everyone I have met appears to be doing this and it is a very good idea.

I expect soon to be able to move into a fixed rate which will give me an expected lower cost of funds than floating for the next one, two and three year periods. Come June the forecast average for floating over the coming year becomes 6.9%. In June therefore if the fixed rate is anywhere near its current 6.25% I grab it. Also come June the forecast average for floating over the following two years will become 8%. That makes a two year fixed rate near the current 7.2% quite attractive.

The forecast average for the floating rate over three years will become 8.5%. I might fix for three years if the rate were close to the current 7.95%. Actually I wouldn't as the jump to 7.95% is too great from floating this year.

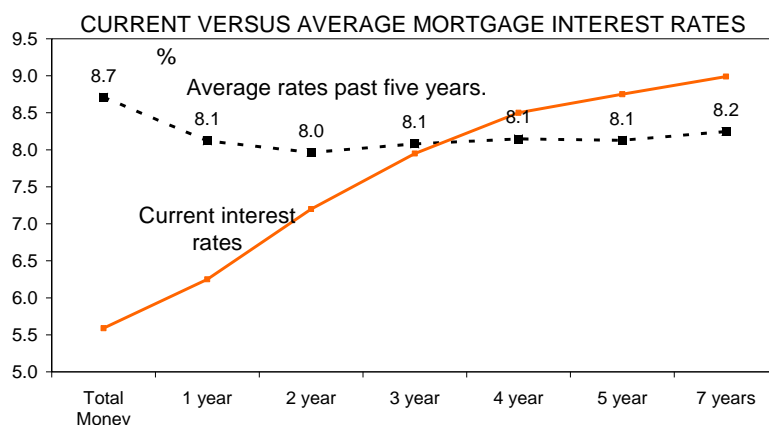
Therefore, come late-May, if I am presented with a two year rate very close to the current 7.2% I would currently plan to take it and achieve a lower debt cost for the next two years than riding the floating rate up. I will of course be hit in two years with whatever the floating rate is doing but that is another story.

The thing to watch will be whether – come late-May – we still think the Reserve Bank will increase the official cash rate 0.25% every six weeks starting on June 10, and whether the world growth outlook has radically changed.

So last year from January to March 18 our focus was on sitting floating waiting for fixed rates to bottom out then locking in as long as one possibly could. We put out our fixed call on March 19 and the next few weeks proved very interesting as many borrowers jumped from floating to fixed. This year our strategy again is to sit floating but not waiting for fixed rates to bottom out, simply holding tight to enjoy the 5.59% rate for as long as possible before taking a one or two year fixed rate to avoid rising floating rates for a period of time. This time around the strategy is not about snapping up a bargain, it is simply about mitigating the impact of the rate rise cycle.

The volume of funds likely to make this jump come May and early June – if the conditions are right – will likely be a lot less than last year. And because the demand for three year fixed rates and beyond will likely be minimal banks should not have great problems switching their own funding from floating to fixed.

The graph here shows where fixed rates sit currently in comparison with their averages over the past five years.



## HOUSING MARKET UPDATE

### Elephants

There are three big elephants in the housing room. Tax, debt, and supply. There are of course lots of other factors such as the level of and changes in interest rates, population growth, the decreasing average number of occupants per house, construction costs, employment, confidence and so on. But those things are "normal" as it were and one can spend time trying to develop a model incorporating such things which aims to predict where house prices will go. Personally we have never seen such models work in practice and certainly none predicted the extent of the sharp rises in house prices through to the end of 2077.

What we have now are three big factors about which we can only make slightly informed guesses as to their impact. Lets start with debt. Around the world debt levels got out of control as money was very willingly lent to banks by investors, willingly lent by those banks to borrowers, very willingly borrowed by those people, with the whole thing poorly supervised by the regulatory agencies.

Household debt ratios soared and overseas we can see people refraining from spending as they seek to get their debt levels down. Governments are now doing the same thing and the business sector around the world is quite reluctant to borrow. Here in new Zealand this process whereby businesses and householders are deleverage their balance sheets is well under way.

Over calendar 2009 household debt grew by only 2.7% with no sign of that growth accelerating in the latter part of the year in spite of the lowest floating mortgage interest rates in four decades. Even the surge in housing turnover and recovery in prices between January and roughly October was not accompanied by a large lift in household debt growth. It went from averaging 0.1% a month in the six months to March to 0.3% in October and is now at 0.23%.

Businesses are paying back debt quite rapidly. In the December quarter business debt fell \$2.7b whereas it grew \$2.4b over the same period a year ago and \$666mn a year before that. Business debt fell 7.3% over 2009. Farmers have also pulled their horns in with debt growing 8% over 2009 from 22.2% over 2008 and falling \$315mn in the December quarter versus growth of \$1.3b a year earlier and \$1.1b two years ago.

How long will this period of debt reduction last? No-one knows. The longer it goes on the less will be the recovery in the housing market and business investment. Are Kiwis as shocked as people overseas about the recent events or do we tell ourselves things were much worse in the late-1980s? Only time will give us these answers. Our assumption is that high caution will continue and businesses will probably keep paying debt down through this year. But we expect household debt growth to be lifting before the middle of the year.

Second, housing supply. If we take the low estimate that we need 23,000 new dwellings to be built each year to house growing population, replace aged buildings etc., then we need about 1,916 consents to be issued a month. The last time that happened was in April 2008 courtesy of apartments – a market now well and truly on its knees with regard to construction because of reduced investor interest and lack of finance.

Consent numbers have average 1,404 over the past three months which is up from 1,197 three months ago and 1,166 three months before that. But the growth in numbers stalled over November and December and because consent numbers tend to follow dwelling sales the recent sharp decline in sales is likely to lead to a pullback in consent issuance as well.

As each month goes by the under-supply of houses will grow. Construction on an annual basis has been below 23,000 since July last year and is currently just 14,425. Will weak construction continue this year and next? Will there be a surge? How will the lack of finance company lending to developers affect new supply? The reduced interest from investors? An outflow of skilled tradespeople to Australia and other sectors?

There is no model which tells us these things but we don't expect to see 23,000 consents issued on an annual basis until some time in 2011.

Third, tax changes. We don't know exactly what they will be but it seems reasonable to assume depreciation allowances for buildings will disappear and maybe even fittings though we have heard nothing in that regard. Investors will be running through their numbers. Some will decide to sell – either soon or sooner than they were thinking. Others will decide not to buy or to buy later.

The impact will be some downward pressure on prices. We don't know by how much however.

This state of uncertainty about these three elephants will continue all this year and well into 2011 and it is likely they will keep activity levels and prices subdued. But they and other factors are unlikely to change the long term trend toward higher prices and almost certainly prices continuing to trend upward over the long term relative to incomes.

1. The debt effect will be temporary. Eventually people will become more willing to gear up, probably when the labour market is a lot stronger.
2. The tax effect is temporary in the sense that it causes a one off shift in the demand and supply curves bringing a change in the equilibrium point. The changes are not continuous.
3. The longer the under-construction continues the greater the undersupply of housing stock and the longer it will take to fix it. A key point we stress in regard to this is that by the time construction is ramping back up again the availability of labour is likely to be much less than now. Plus the removal of most finance companies from the residential subdivision development scene is structural. And much as it gets talked about, we think the council-imposed restrictions on development of land for residential purposes is also a structural thing unlikely to be strongly reversed in the next few years.

Throw in offsets from rising interest rates and decreasing migration inflows, but also an aging population increasing the downward trend in the number of occupants per dwelling and one gets our picture of the current easing in house prices being temporary. Our analysis suggests no collapse in prices and no boom in prices over the next few years. Both extravagant optimists and pessimists will be disappointed.

As was the case late in 2008 and early last year, the environment is once again going to produce some property acquisition opportunities for long term investors with existing large portfolios managed like a business rather than a tax-driven capital gain punt.

And one final point. While removing the tax advantages of residential property investment will plug a growing fiscal hole, it seems very unlikely that there will be some large scale diversion of investor funds from property into housing. We are not talking about people devoting a pool of money each year to take advantage of tax breaks to produce fields of candy floss which they will now change to producing sheep for productive export. The houses people invested in will remain. Someone will own them. The stock of money in housing will not change. There will be no large pool of money freed up to invest elsewhere. And if in the future such a pool of money does grow it will only happen because fewer houses are being built.

Worse than that – the bulk of the money supposedly wastefully invested in the houses we need to live in was largely borrowed. It was not equity. If we invest less we borrow less and that means only a small amount is actually available to move to another investment.

The only two issues of relevance to the economy with regard to the investor preference for housing are higher prices making home ownership more difficult, and a tax loss for the government. The tax changes will sort out the latter problem. The former is going to get worse as construction will be less than would otherwise be the case – and rents rise. Then prices.

### **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**

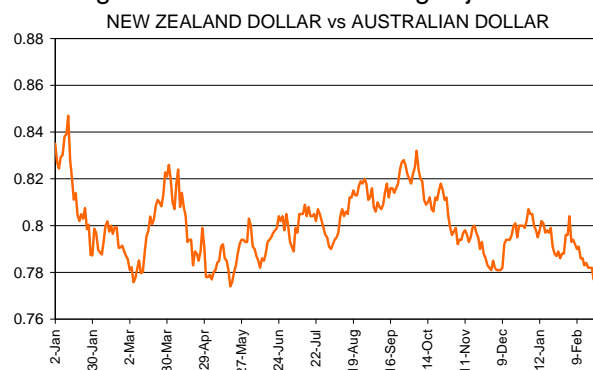
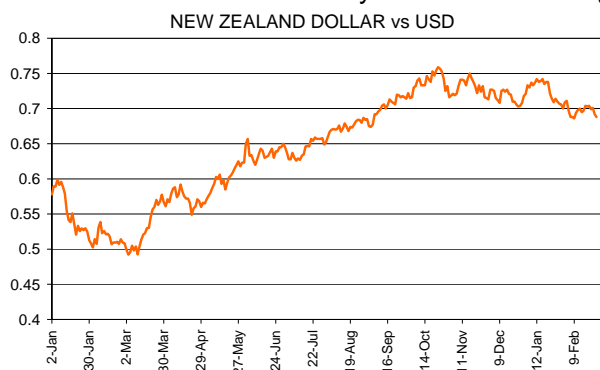
- Dwelling consent numbers to recover now with potentially good activity from mid-2010.
- Real estate sales continuing to increase but the rise limited by listings shortages.
- House prices edging higher subject to tax changes bringing short term downward pressure.

## 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	0.688	0.703	0.709	0.724	0.5141	0.573	0.592
NZD/AUD	0.774	0.782	0.787	0.788	0.7891	0.848	0.856
NZD/JPY	61.70	64.00	63.90	64.00	49.64	59.0	66.8
NZD/GBP	0.448	0.448	0.440	0.437	0.3551	0.358	0.345
NZD/EUR	0.516	0.516	0.500	0.484	0.4003	0.448	0.51
USD/JPY	89.68	91.03	90.12	88.39	96.56	103.0	113.9
USD/GBP	1.536	1.569	1.611	1.657	1.448	1.601	1.709
USD/EUR	1.333	1.362	1.418	1.496	1.284	1.278	1.156
AUD/USD	0.889	0.899	0.901	0.919	0.652	0.676	0.69

### NZD Eases Again

The NZD ended last Thursday near 70.3 cents against the greenback but this evening is just under 69 cents.



The main source of downward pressure on the NZD this week was a rise in risk aversion associated with

- US consumer confidence measured in the monthly Conference Board survey falling to 46 in February from 56.5 in January. A reading of 56 had been expected.
- The credit ratings on four Greek banks were cut.
- German business sentiment data came in worse than expected.
- US housing market data again came in weaker than expected.

As each ay or week goes by we are tending to see a reinforcing of the general picture that world growth is improving but there are some big obstacles along the way which cause investors to worry how other investors will feel about them. Will there be generalised selling of risky assets because of concerns about the poor Greek government finances which will take years to correct? Can the UK adequately finance its deficit in light of recent numbers showing it to be much worse than expected? Will the Euro be able to hold together in light of the disparate performances of member economies and the debt problems?

How much are the Chinese seeking to slow their growth and will they be able to do it in a smooth fashion? Could the very strong bidding in the Hong Kong residential market last weekend be a sign that underlying inflationary/speculative pressures are even greater than they thought?

These sorts of worries and the general ending of the period of euphoria following the appearance of Green Shoots a year ago showing a Depression was being avoided help account for the Kiwi dollar's decline from US 76 cents in October. If worries grow the NZD will decline further. If worries ease it will go back up with big assistance expected mid-year from monetary policy tightening.

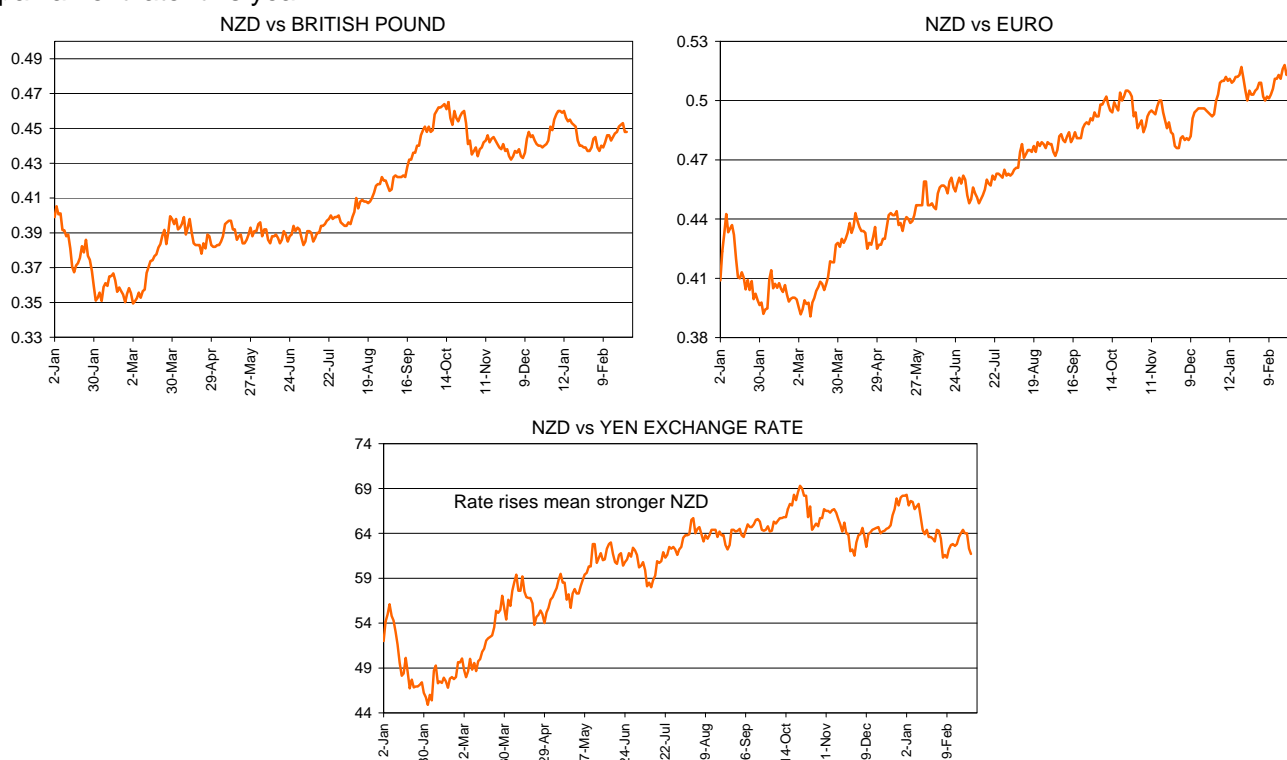


## BNZ WEEKLY OVERVIEW

Our view remains that policy tightening in NZ will see the NZD rise so we remain of the view that the current period of weakness in the NZD provides some good opportunities for exporters to hedge. But just remember – hedging should reflect one’s underlying vulnerability to exchange rate movements and not a forecast of where a rate is going to go. After all, no-one has a record of successful currency prediction and we have shown in the past how forecasting the NZD a year ahead is essentially the same as tossing a coin. Good luck.

Of intense interest for many exporters will be two NZD cross rate changes during the week. The first is the NZD’s continued easing against an Aussie currency underpinned by firm economic data, increasing talk of a multi-year minerals boom, and expectations of the RBA raising their cash rate again very soon. The NZD has fallen to near the lowest level against the AUD in a decade.

But against the British pound we have held at 48.8 pence this week with a good chance we go higher in the near future due to the deepening concerns about the state of UK finances and the possibility of a hung parliament later this year.



### If I Were An FX Receiver What Would I Do?

Nothing new. Will include graphs again next week.

\*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	-0.2%	1.3	2.0	3.4	3.2
GDP growth	Average past 10 years = 3.0%	+0.2	0.2	-2.2	1.5	2.1
Unemployment rate	Average past 10 years = 5.3%	7.3	6.5	.....	4.7	3.5
Jobs growth	Average past 10 years = 1.9%	-0.1	-0.8	-2.4	0.9	2.1
Current a/c deficit	Average past 10 years = 5.5% of GDP	5.9	8.1	.....	8.3	8.2
Terms of Trade		-1.2	-9.4	-13.8	5.8	8.4
Wages Growth	Stats NZ analytical series	0.4	0.8	2.7	5.4	5.0
Retail Sales ex-auto	Average past 9 years = 3.8%	1.3	0.7	1.3	-0.6	2.8
House Prices	REINZ Stratified Index	2.8	2.5	6.0	-7.9	8.0
Net migration gain	Av. gain past 10 years = 11,700	+21,253	17,043yr	.....	3,814	5,494
Tourism – an. av grth	10 year average growth = 5.0%. Stats NZ	-0.0	-1.8	-0.0	-0.3	1.8
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Consumer conf.	10 year average = 2%. Colmar survey	52	57	3	5	2
Business activity exps	10 year average = 26%. NBNZ	41	37	26	-20	2
Household debt	10 year average growth = 11.3%. RBNZ	2.7	2.7	2.4	4.2	12.4
Dwelling sales	10 year average growth = 3.5%. REINZ	15.2	41.5	40.3	-23.1	-32.1
Floating Mort. Rate	(Total Money) 10 year average = 7.6%*	5.59	5.59	5.99	7.75	9.99
3 yr fixed hsg rate	10 year average = 7.9%	7.95	7.45	6.99	6.99	9.40

**ECONOMIC FORECASTS**

Forecasts at Jan 28 2010	March Years					December Years				
	2008	2009	2010	2011	2012	2007	2008	2009	2010	2011
<b>GDP - annual average % change</b>										
Private Consumption	3.2	-0.8	-0.2	1.8	2	4.1	-0.1	-1	1.6	2
Government Consumption	4.2	3.3	0.8	2.7	1.9	3.8	3.8	1.3	2.3	2.2
Investment	4.2	-8.8	-11.5	5	8.8	4.9	-5.2	-13.7	1.3	9.6
GNE	4.2	-2	-3.3	4	3.4	4.4	-0.1	-4.9	3.3	3.7
Exports	3.1	-3.3	-1.3	0	4.9	3.9	-1.3	-2.4	-1.3	4.7
Imports	10	-4.7	-13.9	3	5.9	8.9	2	-17.3	1.2	5.6
GDP	3.1	-1.1	-0.7	3	3.1	3.2	0	-1.6	2.3	3.3
Inflation – Consumers Price Index	3.4	3	2.5	1.1	2.6	3.2	3.4	2.6	1.4	2.1
Employment	-0.3	0.8	-1.6	2.6	3.2	2.3	1	-2.9	1.7	3.4
Unemployment Rate %	3.8	5	7.4	7.2	6.2	3.5	4.7	7	7.4	6.3
Wages	4.4	5.1	2.4	1.5	3.8	4	5.1	3.1	1.3	3.3
<b>EXCHANGE RATE ASSUMPTIONS</b>										
NZD/USD	0.8	0.53	0.76	0.73	0.65	0.77	0.56	0.75	0.75	0.67
USD/JPY	101	98	92	105	109	112	91	88	104	108
EUR/USD	1.55	1.31	1.48	1.44	1.4	1.46	1.34	1.49	1.45	1.41
NZD/AUD	0.87	0.8	0.82	0.83	0.8	0.88	0.83	0.81	0.83	0.82
NZD/GBP	0.4	0.37	0.46	0.42	0.38	0.38	0.37	0.47	0.43	0.39
NZD/EUR	0.52	0.41	0.51	0.51	0.46	0.53	0.41	0.5	0.52	0.48
NZD/YEN	81.1	51.8	69.5	76.7	70.9	86.3	50.9	66	78	72.4
TWI	71.6	53.8	67.9	68.3	62.8	71.6	55.1	66.9	69.6	64.4
Official Cash Rate	8.25	3	2.5	4.25	6.25	8.25	5	2.5	3.75	5.75
90 Day Bank Bill Rate	8.91	3.24	2.7	4.62	6.62	8.9	5.23	2.76	4.12	6.12
10 year Govt. Bond	6.36	4.77	5.75	6.3	7	6.4	4.88	5.5	6	6.8

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 Total Money started in 2007