

BNZ Weekly Overview

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 with 'Subscribe' in the Subject line.

Lifting New Zealand's Management Performance

New Zealand long ago waved goodbye to the top notches of the OECD ranking of income per capita and as each year goes by our ranking faces downward pressure from developing economies moving away from low income activities toward highly sophisticated products and services bringing rising incomes to their people. It is very unrealistic to think that as an economy with an export base more dependent upon the primary sector now than in the early 1970s and located so far from principal markets that we will ever seriously go back up the ladder.

But that is not to say we will not experience rising income per capita because clearly we do and we will. The question is how to maximise that growth. There is a lot of work being done by various government agencies in this area with increasing contributions from private sector organisations like the New Zealand Institute. There are also contributions like our own at the BNZ in the form of being a founding partner of The Icehouse, Chairs in Finance at the Universities of Auckland and Otago, and occasionally bringing skilled people to New Zealand able to offer something, especially in the area of business management. The research is not conclusive but studies by The International Institute for Management Development (IMD) and Ministry of Economic Development suggest that a management capability problem exists in new Zealand which may be one factor holding back productivity growth.

So, with the aim of raising managerial skills in the country BNZ is bringing the well known management guru Tom Peters to New Zealand for a full day workshop on Wednesday 23 February at the Auckland Museum Events Centre. Tom Peters is the well known co-author of what some analysts consider the most influential management book ever "In Search of Excellence".

You'll find full details of the workshop at the web link just below but in summary areas covered at the workshop will include people development, effective leadership, innovation, creating value, execution of strategy, and of course excellence.

www.bnz.co.nz/tompeters

Partial Asset Privatisation – At Last

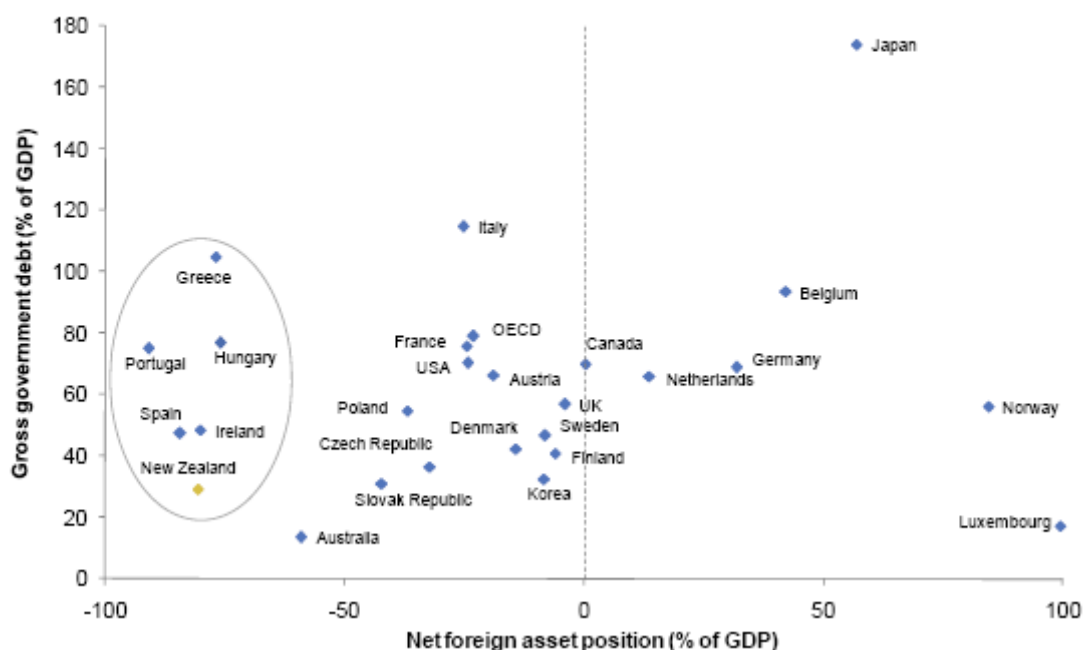
Perhaps emboldened by the political polls and certainly driven by the need to improve fiscal policy and management of the Government's \$223bn worth of assets the Prime Minister this Wednesday announced that he has instructed Treasury to look at options for partial privatisation of the government's three electricity companies, Solid Energy, and Air New Zealand. The rules will be retention of at least 50% ownership by the Crown, ownership offered first and primarily to New Zealand individuals and institutions, and reinvestment of sale proceeds in other government assets (roading, broadband etc.)

Doing this will start to reduce the government's current borrowing need of \$300mn a week and contribute to improving the country's savings rate which is already getting a boost from reducing levels of debt in the business sector and essentially zero growth in household debt. The Government is also going to use the Budget to bring forward by one year the projected period of return to fiscal surplus from 2015/16 to 2014/15. The central theme for this year's Budget will in fact be savings and investment.

The partial privatisations will of course only happen if the above conditions can be met and if National win at this year's general election. But given what the polls are showing it seems probable National will win – though finding adequate coalition partners will be the biggest challenge.

In a world where investors are wary of countries with bad government accounts and where future financial shocks seem virtually guaranteed it is important that the government move its accounts toward surplus as quickly as possible and avoid myopic election giveaways which leave a growing fiscal hole. This is especially important here in New Zealand because with net international liabilities equal to about 85% of GDP we were only saved from economic collapse along the lines of Greece, Ireland etc. by reforms of many years ago (thanks Roger, Ruth and Bill) and by the government having run surpluses for about 15 years (thanks Michael, pity about the other stuff). The graph here from NZ Treasury fairly much says it all.

Figure 1 - Government debt and net foreign asset position (2008)

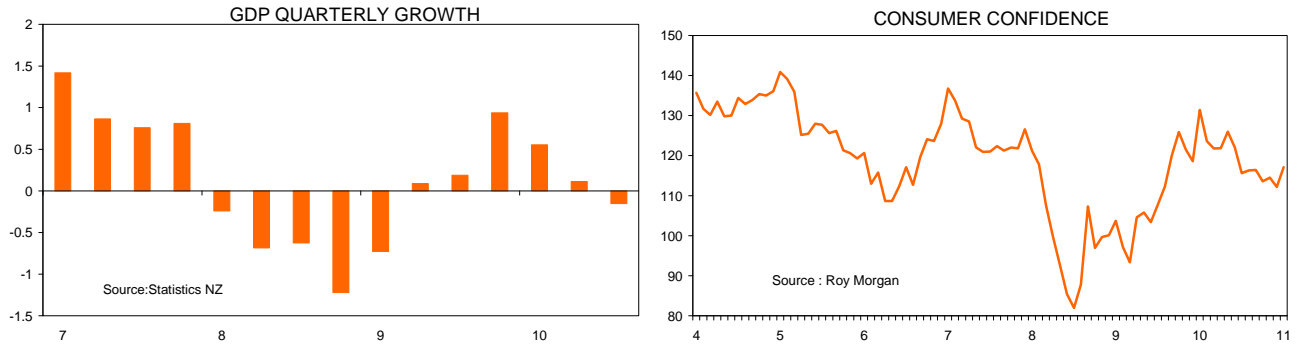


The graph shows along the horizontal axis the ratio of net external liabilities to GDP which we all know for New Zealand is truly appalling because we have been running current account deficits since 1974. We pay for these deficits by borrowing money (largely private sector) offshore and selling more of our assets to foreigners than we buy of theirs.

The vertical axis shows gross government debt as a percentage of GDP. Look at the beautiful neighbourhood we are in – Ireland, Greece, Spain, Portugal, and Hungary. All countries with major sovereign debt problems.

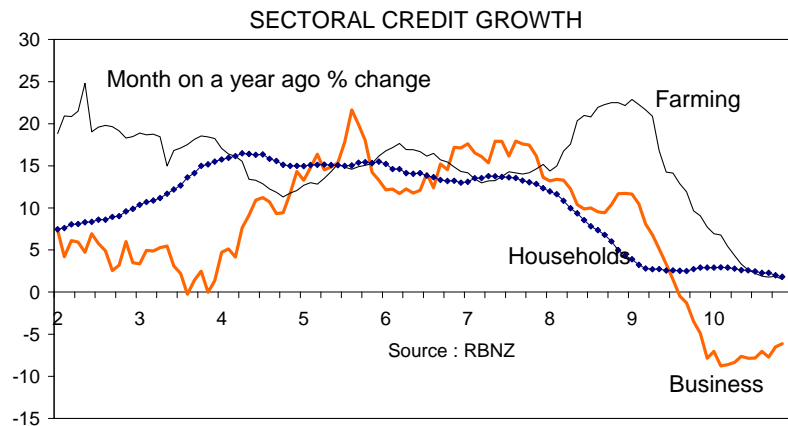
Debt and Savings

One of the factors if not the key factor explaining why the NZ economy failed to grow at all over the June and September quarters of last year was a drive by businesses and households to get debt levels down. Confidence levels were good over and before that period of time and there were some stimulatory factors in play such as the lowest borrowing costs since the 1960s and rapidly rising commodity prices.

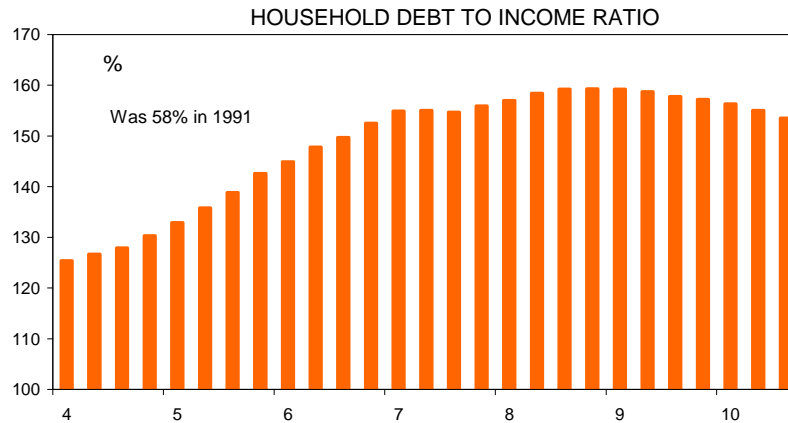


Which just goes to show you need to treat confidence survey results with great care over short periods of time. Just because someone is smiling does not mean they are doing good things. Or maybe in the current context they smile because they are not spending and it feels good after two decades of buying everything the retailers put in front of them.

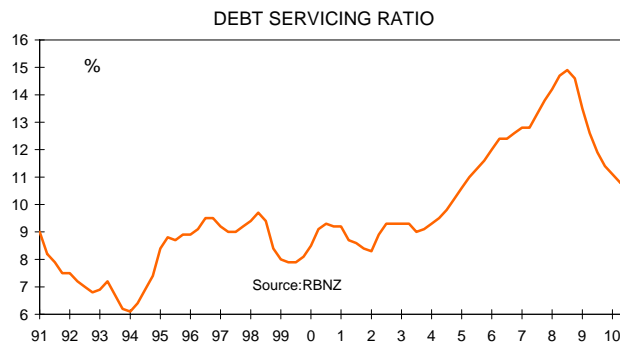
So, given the ready availability of evidence showing we are not growing our spending much, can we see evidence that we are saving more? If we look at the lending aggregates as we do every month it is clear that businesses are paying down debt, farmers have almost stopped borrowing more to buy each other's farms, and households have also almost completely ceased building up their debt levels.



We can't do this exercise for the business sector but for the household sector we can take a look at how debt is tracking when compared with incomes. Taking data from graphs updated on the Reserve Bank's website we get the following showing how the ratio of household debt to income has decreased from a peak of 159.3% in the December quarter of 2008 to 153.5% in the September quarter of last year. This is not that big a correction after years of increases which took the ratio from under 58% back in 1991.



But the near cessation of lending growth when coupled with low interest rates has allowed the debt servicing ratio for households to fall to its lowest level since the March quarter of 2005 at 10.8%. Note that this ratio was 9% in 1991. Why isn't it three times that given the debt to income ratio is almost three times what it was back then? Because back in 1991 the average mortgage interest rate was 15.6% and now it is less than half that at 7.1%.



Household finances are slowly improving and further gains are likely. But can we take a stab at when households will once again lift their credit demand and start spending again? Unfortunately not and it pays to keep in mind that no sane person back in 1991 was talking of the household debt to income ratio rising to 100%, and no-one in 1999 when it hit that level was thinking in terms of the ratio rising above 150%. Some things you simply can't forecast and you have to take them as they come – which is fairly much our theme for a lot of things this year, especially the major areas of contention offshore such as European debt, US housing, rising commodity prices, and the extent to which bubbles are developing in various asset markets due to continued strong money supply growth at a time of reasonable world growth.

For businesses the main implication of this environment is that risk management needs to take a more central stage than has traditionally been the case. One can't simply plan for our forecast of house construction turning up later this year for instance and ignore the risk that something bad happens overseas and house buyers and developers crawl even further into their shells.

Did you know that whereas back in the middle of 2007 total finance company lending within NZ stood at \$16,832 it stood at \$11,969 in September last year. As a proportion of total NZ lending that means a fall from 6.4% to just 4.1% illustrating two things. First, finance companies were never that large a part of the financial system in NZ. Second, they were large however in the riskier end of the property sector and because we banks stepped back from such borrowers from the early 1990s and are not going to take them on now lots of things which would have been built will now not be built – and given the losses many such things have brought for debenture investors that is an extremely good thing and a contributor to less wastage of resources in our economy.

Is Our Economy Getting Better or Worse?

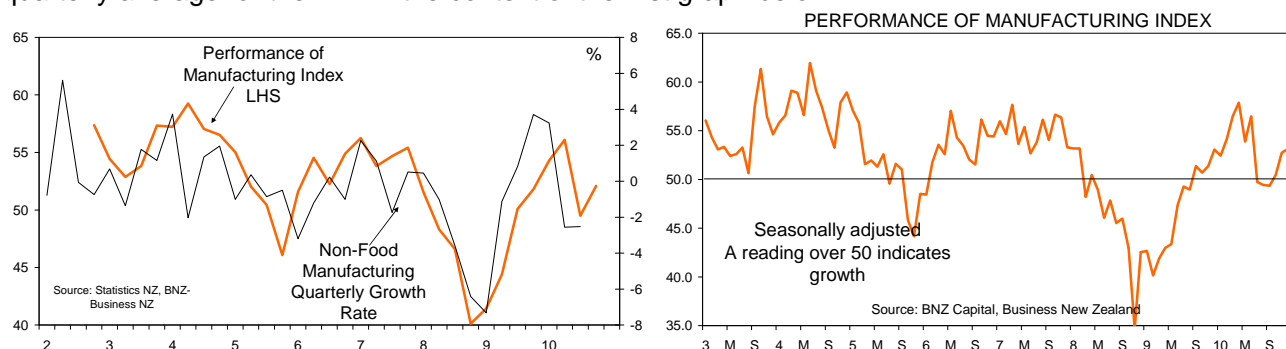
In this simple summary section we look only at what the data are actually telling us and pay no attention to forecasts or intentions measures. Other sections have more detail on retailing and housing.

Are householders opening their wallets more?

We already have December data for Electronic Card Transactions showing a 1.6% fall in core retail spending and quarterly spending growth running at about half the long term average. The data show consumers with their hands firmly in their pockets. This week we received the well out of date retail trade numbers for November and the core measure there fell 0.2% which was a lot weaker than had been expected especially as the core ECT change for the month had been +0.4%. The data continue a string of indicators showing we householders prefer debt repayment to spending up large and given that retail spending makes up about two-thirds of private consumption which makes up two-thirds of overall expenditure in the economy the weak retail spending suggests the December quarter was another one of very little growth in our economy.

Is business output rising?

The BNZ Business NZ Performance of Manufacturing Index which broadly tracks changes in non-primary sector manufacturing output firmed to a reading of 53.1 in December from 52.7 in November. The index has been marginally above the 50.0 no growth level for three months in a row now and we feel that allows one to say that the manufacturing sector is growing or at least close to growing when one considers the recent quarterly average for the PMI in the context of the first graph below.



Generally around the world (except in Australia) manufacturing sector readings have been improving recently so the NZ growth story is nothing out of the ordinary. And perhaps all we can take from the latest data is that at least this sector of our economy is improving - but it is not soaring.

Are businesses hiring more people?

Just a reminder that Australian employers are. Maybe you can speak with some of them in a couple of weeks at the Oz Jobs Expo in Auckland on February 12th and 13th. www.ozjobexpo.com

Are businesses boosting their capital spending?

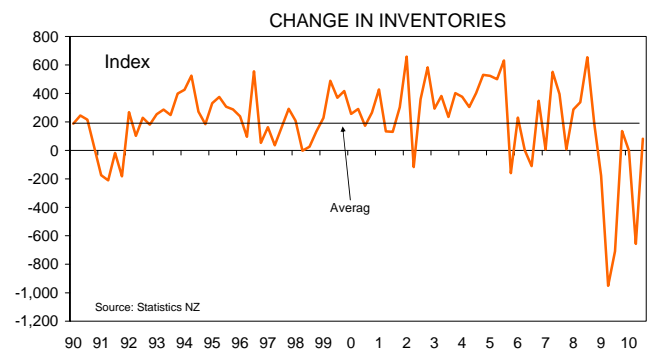
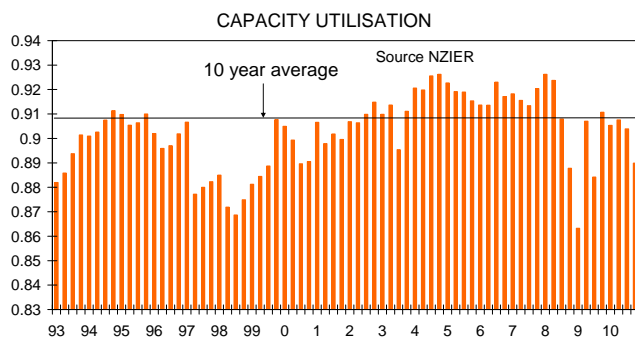
We have received no new information in this area this week. Our analysis of the most recent data tells us that business capital spending is growing but history says it could be quite some time before this spills over into higher business sector credit demand. Traditionally NZ businesses are wary of debt and prefer to use retained earnings in the initial couple of years of a recovery to finance capital expenditure. That is especially the case this time around with high awareness that banks have tightened up their lending criteria in a world where raising funds to on-lend is more difficult and more expensive relative to central bank interest rates than was the case in the past.

INTEREST RATES

Growth vs. Economic Slack

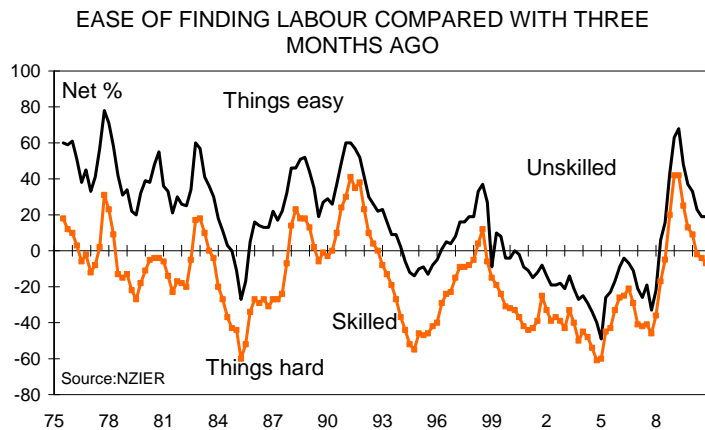
In a nutshell this is what drives inflation along with institutional arrangements, imported inflation, and exchange rate changes. If you want to forecast monetary policy you need to monitor these things. So we will, adding stuff here when we learn it. The current common view is rate tightening from June-September. Have we learnt anything this week which alters this outlook?

This is the first time we have explicitly done this exercise in a formal manner so lets cast our net back a few weeks as opposed to just the period since last Thursday. First what is the economy's capacity picture looking like? The more spare resources the more growth we can handle (if it comes) before inflation needs to be worried about. The NZIER's Quarterly Survey of Business Opinion of a couple of week's ago recorded a fall in the capacity utilisation rate for the manufacturing and construction sectors to 89% (not a % really but lets ignore that) from 90.4% in the September quarter. The December quarter average for this reading is 90.9% and for the September quarter 90.8% therefore the 1.4% decline is unequivocally a freeing up of some capacity. That reduces the inflation risk.



The September quarter national accounts revealed an \$82mn rise in inventories which was only a small recovery after the \$657mn fall in the June quarter and well below the average addition per quarter of \$195mn. The recent sharp decline in stock levels has largely removed the excess which built up over the period from 2007-09 so ability of businesses to meet output demand using inventories is probably close to normal on average and not signalling much with regard to inflationary pressures.

The NZIER's QSBO revealed a net 7% of businesses find it hard to get skilled labour. This is a tad harder than 4% in the September quarter and although the most difficult hiring environment since the June quarter of 2008 is well away from the average reading of a net 26% difficulty. The market for skilled labour remains unworrying for employers. The same goes for unskilled labour with the net percent finding it hard to hire unskilled people at in fact 19% finding it easy which is the least easy position since mid-2008 but well away from the average of a net 5% finding things difficult. So unskilled labour is also plentiful relative to what employers are seeking. This implies little pressure on wages at the moment.



From this point we can shoot off for pages discussing factors driving expected growth in the economy and what they therefore imply for inflation in the 18-24 month period in the future the Reserve Bank is aiming at.

But lets just cheat and start from a position of everything already being factored into market pricing of a few weeks ago and simply ask ourselves if indicators over the past few weeks suggest faster or slower growth in our economy than previously thought. They suggest slower. (Note we see a need for tighter interest rates further out to slow growth as resources become less available, especially in the labour market which could tighten up quite quickly this year and next.)

An easy starting point is in the fact the monthly Consensus Economics survey of GDP predictions. In the December survey the expectation on average was that our economy would grow 3.3% this year. The January survey reveals an average expectation of 2.9% growth only some of which one can be put down to a lower starting point because the September quarter national accounts numbers released on December 23 were worse than expected. The expectations for our growth have worsened this year therefore this implies reduced pressure for tighter monetary policy.

We have also seen recently the release of much weaker than expected official retailing data for November, very weak core Electronic Card Transactions data for December, weak housing consent numbers for November, plus flat to slightly better data for real estate activity and manufacturing. These things on average also reduce inflation risks as does the interesting growth in capital spending which implies better productivity growth.

Taken together all of these things reduce the chances that the official cash rate will rise in June and make September for the moment increasingly likely. However, there are other things to consider.

Other Inflation Influencers

One obvious thing is actual data on inflation. Global food, raw material and energy prices have risen further in recent weeks and this implies extra inflation than one would have been thinking a few weeks ago. The floods in Queensland also imply more rapid slowing in labour force growth than earlier thought as more people are attracted across to Australia for rebuilding property and infrastructure.

In addition growth expectations for the United States and Germany have improved recently while China's economy is reported to have grown faster than thought during the December quarter. But at the same time the Aussie economy has shown weakness in household spending and housing late last year with the result that their December quarter inflation measure rose only 0.4% and not the 0.7% expected in the marketplace or the 0.6% forecast by the RBA. This is a mild positive for our inflation though all of that will change in extremely uncertain fashion as first of all their inflation jumps up in this quarter due to soaring fruit and vegetable prices, then their economy faces resource strains from rebuilding efforts kicking off now in earnest.

Then there is fiscal policy. This really feeds into the growth versus capacity section just above but we shall put it separately here because this was an important week for it. The Prime Minister yesterday announced that fiscal policy will be tightened more rapidly than indicated at last year's Budget and in Treasury's Half Yearly Economic and Fiscal Update of just over a month ago. The change to be announced in this year's Budget won't be grand – just one year to be shaved off the period before surpluses return, but this is important for the Reserve Bank. It implies a tad more restraint on growth than they were thinking therefore again increases the chances that they delay monetary policy tightening.

All up it is not yet a slam dunk case that the next official cash rate rise will be in September rather than June. But that is where the risks lie. And there was nothing in this morning's review of the official cash rate by the Reserve Bank to alter those odds. The RB left the rate unchanged at the 3% it was taken to in July last year, noted recent weakness in retailing, ending of the recent decline in housing, upturn in capital spending, strong export prices, and good growth prospects offshore, then used exactly the same sentence to describe their monetary policy intentions as was used in the December review. To whit...

"...while interest rates are likely to increase modestly over the next two years, for now it seems prudent to keep the OCR low until the recovery becomes more robust and underlying inflationary pressures show more obvious signs of increasing." So that was that. Boring thankfully.

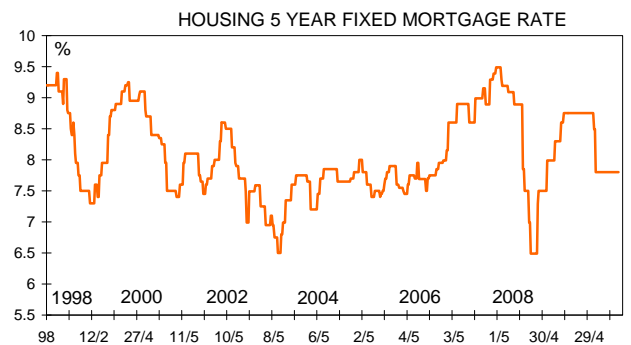
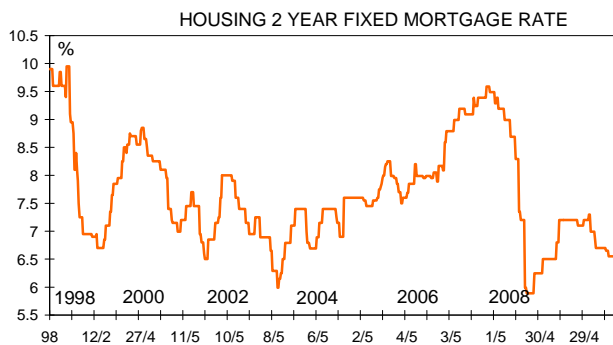
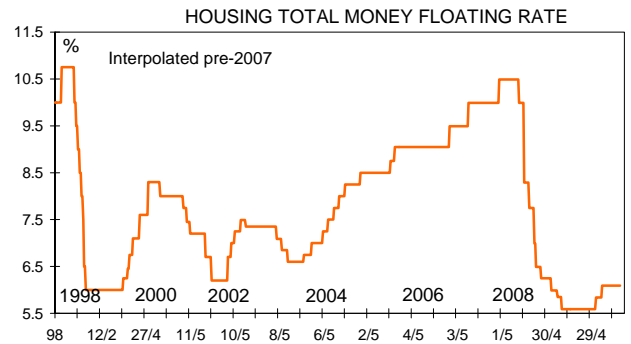
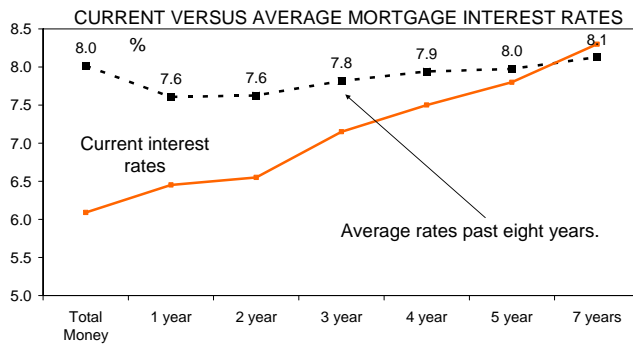
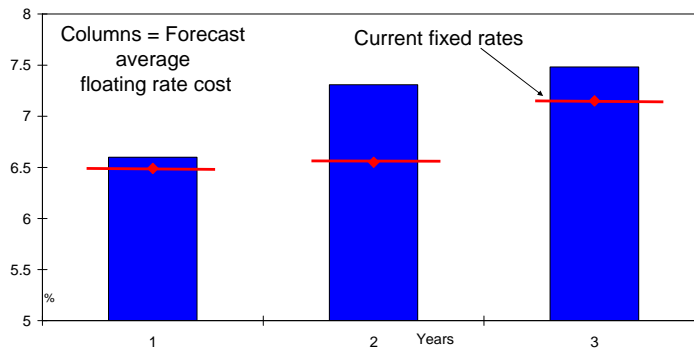
FINANCIAL MARKETS DATA

	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	3.00%	3.00	3.00	3.00	2.50	5.9
90-day bank bill	3.20%	3.20	3.19	3.20	2.77	6.2
1 year swap	3.44%	3.49	3.44	3.44	3.65	6.3
5 year swap	4.73%	4.74	4.90	4.48	5.38	6.6
180-day term depo	4.10%*	4.10	4.80	4.90	3.15	6.0
Five year term depo	6.50%	6.50	6.75	6.75	6.00	6.5

* 160 days = 5.2%

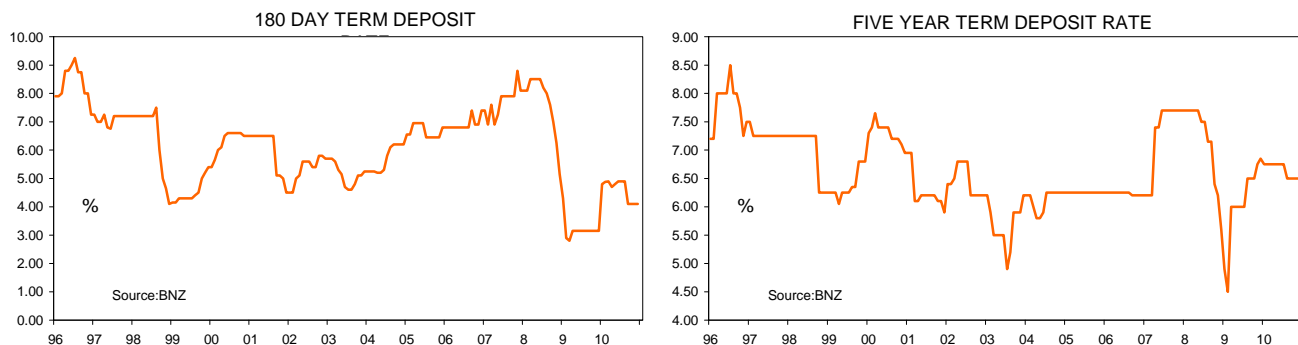
If I Were a Borrower What Would I Do?

I'd stay floating for now and only jump into a two year or beyond fixed rate if I were offered a rate much lower than currently available.



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

Take a spread of term rates. Nothing interesting to say here sorry.



HOUSING MARKET UPDATE

Turnover is weak, construction falling, and prices essentially flat on average.

Going Nowhere

We've learnt nothing much new about the NZ housing market this week apart from confirmation from the real estate company First National Group that while there are rental shortages in Auckland, Nelson and the Bay of Plenty, the rest of the country is awash with rental accommodation. We have no database in hand to assess the comments from FNG however so will just take their words as largely reflecting what we already know about Auckland and the generally weak state of real estate markets in most of the regions.

There is also not much worth saying that is new with regard to the annual Demographia International Housing Affordability Survey. The survey shows housing as highly unaffordable in New Zealand when one compares average prices with average incomes. And so we wring our hands worrying about how young people will be able to afford to buy a new house. Then we make sure our own home prices are protected by not supporting huge swathes of land being opened up on the outskirts of our cities, by setting up and expanding our businesses in the large centres rather than the regions, and helping to finance our kids into their first home. We make sure investors remain incentivised to not sell their properties by keeping capital gains tax free, we support rising construction costs with more stringent insulation requirements and construction methods aimed at avoiding another batch of leaky homes, and we bemoan the boring sharemarket, the shysters in the finance companies, and the low term deposit rates on offer to justify leaving our money in investment properties.

<http://www.demographia.com/>

If NZ house prices were going to adjust strongly downward in response to the fact that they are expensive by our historical and current global standards they would have already done so by now. Instead what is happening is that as household incomes and consumer prices generally rise house prices are largely sitting still and therefore in real terms house price falls are occurring. Will nominal prices fall however from current levels? Probably not or not by very much. We see scope for some upside surprises to economic growth and therefore jobs growth and wages later this year, construction costs are rising, and dwelling construction is running well below average. These factors don't argue for a period of strong house price gains but they do suggest rising prices again from possibly the second half of this year. But if the current welcome aversion to borrowing continues then house prices may not move all that much.

Are You Seeing Something We Are Not?

If so, email us at tony.alexander@bnz.co.nz with Housing Comment in the Subject line and let us know.

Key Forecasts

- Dwelling consent numbers to improve further out.
- House prices edging higher from second half of 2011.

RETAILING UPDATE

Hit a wall mid-2007, recovery mid-09, but core trend down again since July. Basically weak.

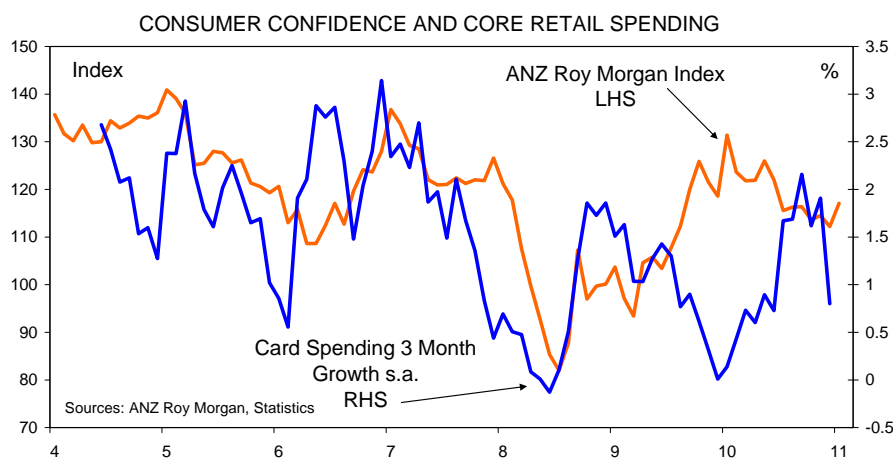
Stuff we're monitoring.....

Housing turnover as if this picks up retailing follows, also jobs growth and confidence but neither will boost retailing if debt repayment remains the focus.

Our expectation is that as the year advances we will see the return of some mild strength in retailing spending – but nothing too startling because frankly we have zero basis upon which to claim that consumers will shift away from debt reduction to spending at any particular point in time. History has shown that we were wrong about a decent part of this shift happening last year so unless your eyes are really filled with stars as regards the forecasting ability of us economists (poor you) you had best play things from the downbeat side with regard to your own expectations and planning numbers for retailing growth this year. If you've got some numbers in there showing more than 5% volume growth for your operation you had better have something extra special going on like a strategy to grow market share or a particular exposure – maybe to the motor vehicle industry.

We say the latter because there is scope for a period of catch-up spending after three years of restraint watching our existing cars get older and rustier. Obviously retailers exposed to the Christchurch rebuilding have some upside – as do those who had their sales badly affected in the December quarter and may now be seeing life returning more to normal.

One factor arguing in favour of things getting better is above average consumer confidence. The monthly ANZ Roy Morgan index rose to 117.1 this month from 112.2 in December. The graph below plots this confidence measure shown in orange against the three month rate of growth in core retail spending captured from the Electronic Card Transactions series compiled by Statistics NZ. The graph shows spending can go through some big fluctuations without confidence changing all that month. This happened in late-2004, early-2006, late-2009, and again now.



What the graph tells us is that the most recently reported Electronic Card Transaction data are probably overly weak in showing annualised spending growth of only 3.2% when the long run average is 6%. The measure is likely to show some recovery soon and highlight again that monthly consumer spending measures in New Zealand can go all over the place so one needs to treat them with a decent lump of salt.

MAJOR OFFSHORE ISSUES

There are many important things happening offshore not easily covered in the one country commentaries we have traditionally included when time permitted in the FX section below. So this new section will concentrate solely on developments in the areas occupying the minds of the markets, policy makers and politicians around the world. In some weeks certain sections will be empty because nothing new will have occurred.

Just in case the five risks we are monitoring here are not enough for you to get worried about you can find 37 of them discussed in the Global Risks Report 2011 released by the World Economic Forum. Enjoy.

<http://www.weforum.org/>

European Debt

Southern Euro-zone governments have soaring debts and/or deficits due to taking on their private sector's debts, or simply their own fiscal incompetence. Concerned by these developments and the lack of suitable EU-wide institutions for handling crises investors are demanding higher and higher interest rates before investing in more debt, causing debt servicing budget blowouts for the recalcitrant borrowers. To try and keep investor confidence some governments are radically slashing spending, raising taxes and restructuring but still borrowing costs climb and the citizenry grow increasingly restless. The logical route is they restructure their debt but that can't happen yet because the bulk of such debt is held by French and German banks and the capital losses could send them bankrupt thus crushing their own economies. What happens then? Lots more investor worries, more official bailout packages as already done for Ireland and Greece, more fiscal austerity and rioting, then when bank capital bases are secure enough debt restructuring will almost certainly come for Ireland, Greece, Portugal and maybe Italy and Spain.

What's new?

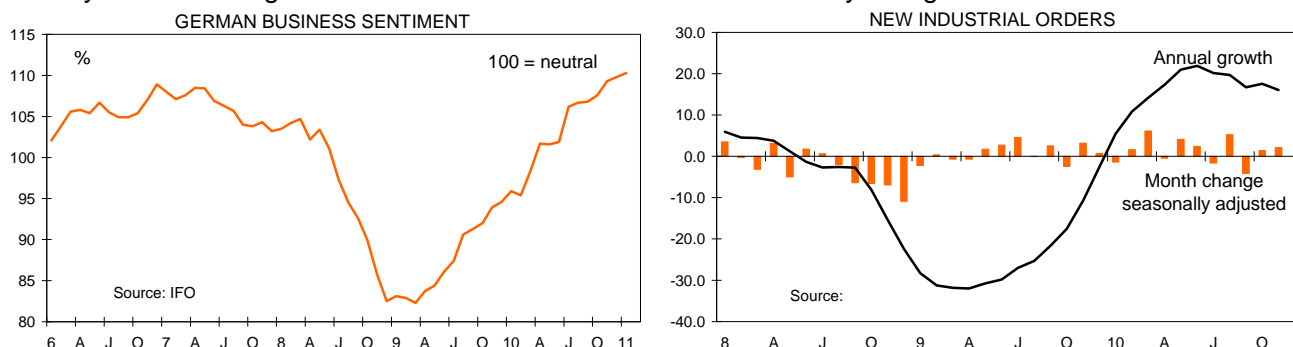
The key development in the European debt crisis this week was strong demand at Tuesday night's first auction of bonds issued by the European Financial Stability Facility. The auction attracted bids from 500 investors with demand exceeding the small €5bn on offer nine times – which in the scheme of bond auctions is quite strong though not ballistic considering this was the first auction of this particular type of debt which is backed by all the euro-zone members. For example at our own Debt Management Office's bond auction of January 20 the bid to offer ratio was 3.5. As promised the Japanese government bought over 20% of the issue and the effective yield on the bonds was 2.89% which is just a tad above the German five year bond yield.

A spokesperson for Moody's indicated Portugal is likely to have its credit rating cut in the next three months because of the high cost of debt servicing. The rate was placed on review for a downgrade in December. The Portuguese however feel they are doing well with growth recently at 1.3% while the budget deficit was cut by over 2%. They've been marketing their debt and products around the planet in recent weeks hopeful of avoiding a bailout. But the chances are some assistance will in the end be necessary.

With regard to progress on improving assistance to debt burdened euro-zone members there is a lot of debate going on usually behind closed doors with a general expectation that something fresh will be agreed upon and announced near the end of March. Probable factors to be incorporated in a revised package include technical changes which will make more of the European Financial Stability Facility available for lending to struggling economies, cutting the interest rate charged on this debt, and allowing countries to use the special bonds to buy back their own debt cheaply. There is little chance of new bonds issued on a regular basis to finance the normal deficits of euro-zone members. Enhancements to the original euro-zone Growth and Stability Pact are likely aimed at avoiding a new slide in future years back into bad fiscal practices.

There was more positive data regarding the state of the euro-zone economy this week which added to positive sentiment toward the euro driven by a growing view that the ECB is shifting its focus increasingly toward fighting inflation rather than standing ready to do whatever is necessary to help out in the debt crisis. Comments over the weekend by the ECB President were once again interpreted as hawkish just as earlier comments were the previous week.

In Germany the IFO Business Climate Index which surveys 9,000 executives rose to post-unification high in January with a reading of 110.3 from 109.8 in December and 95.9 a year ago.



Prospects for manufacturing continue to look good in the euro-zone and in fact the wider EU with orders placed for industrial goods rising by a strong 2.1% following a 1.4% rise in October. In the past three months new orders were ahead 16% from a year earlier compared with 10.7% annual shrinkage at the same time a year ago.

For your guide, the markets are now pricing in rate increases by the ECB this year adding up to 0.75%.

One interesting contrast is between the euro-zone economies and the UK. The former has members with debt levels investors will not tolerate. The latter is being given the benefit of the doubt by the markets. The former has overall growth at a good level principally because of the strongly growing German economy. The latter has an economy which rather than growing 0.5% during the December quarter as had been expected actually shrank by 0.5%. This news this week has caused extra weakness in the pound, a flow of funds into the euro, and taken some attention away from the European debt crisis (for euro-zone members) for the moment.

Chinese Inflation

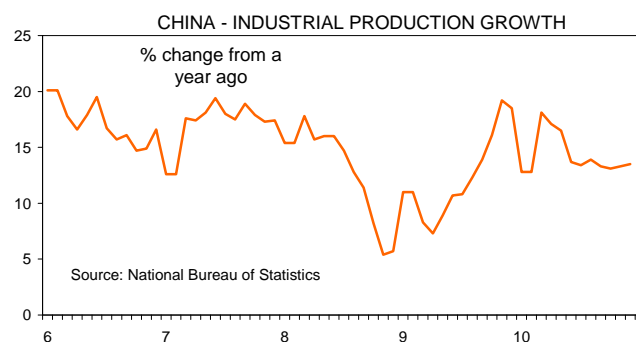
In China high inflation tends to spur non-one party thoughts from the populace à la Tiananmen Square 1989 therefore the leaders will do all they can to get food price rises in particular down. So is inflation easing, what measures will be added to get inflation down? The big global worry is that these measures could produce a sharp slowing in growth which slams sharemarkets, Chinese raw material demand and therefore commodity prices relevant especially for Australia and via them to us, plus our own large dairy and forest product exports to China.

What's new?

The Chinese authorities released data early this week showing GDP growth during the December quarter of 9.8% from a year earlier versus 9.6% annual growth in the September quarter. The market expectation was largely for a 9.2% growth rate therefore the faster than expected growth has raised concerns about the extent to which the authorities will need to take measures to slow down the pace of growth.

But one probably needs to think about this for a moment. Considering the size of China exactly what are the chances that they would be able to generate an accurate GDP number only three weeks after the end of the quarter? Not high. One needs to treat these numbers with a high degree of caution and place each statistical release alongside others to see if there is a consistent picture of improving or easing growth.

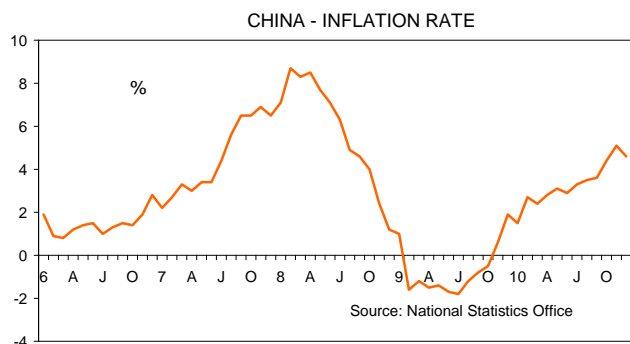
In that regard other indicators remain strong. Retail spending in December was ahead 19.1% from a year earlier assisted by strong car purchases ahead of a rise in the purchase tax for small cars. Over the entire 12 months retail spending was up 18.4%.



Industrial production was ahead 13.5% from a year earlier in December with 1.1% seasonally adjusted growth in the month which was the same as in November. This is the sort of firm result which can help underpin prices for industrial inputs and raw materials in global commodity markets.

The annual rate of inflation eased a tad in December to 4.6% from 5.1% in November but this was largely due to an unusually high December month 2009 number. In the month of December itself consumer prices rose 0.5% following a 1.1% rise in November with December's rise depressed by a 10% fall in vegetable prices which more up to date measures suggest are once again rising. Therefore the inflation rate actually remains quite high in China and additional measures to tighten monetary policy and slow lending growth look certain in coming weeks and months. In fact yesterday the minimum down payment required for the purchase of a second home was increased from 50% to 60% and local governments were directed to set price targets for their property markets. Good luck with that one! For your guide the mortgage lending rate is set at 1.1 times the benchmark lending rate which is currently 5.81% having been increased from 5.56% in December and 5.31% in October. Banks are however allowed to lend up to 10% (of the 5.81%) below the benchmark lending rate but apparently the extent of discounting has been falling away quite a bit recently and extra premiums are being charged as banks seek to build higher margins in an environment where the government is trying aggressively (with very limited success) to slow down lending growth.

It should be noted that just as analysts take growth figures with a sack of salt the inflation numbers are generally considered to understate the true inflation rate.



One thing not to forget about China is that although inflation is high incomes of those in work are growing more strongly. Last week the minimum wage in Beijing was increased 15% for instance. The problem however for the government is that a lot of the inflation is in food prices and older people on low incomes and with time on their hands have a tendency to protest when times get tough. Those protests may be enhanced by the fact that those who save or have saved money can earn a maximum (officially) interest rate of just 2.75% which is well below the inflation rate – hence money pouring into property willingly assisted by banks who have repeatedly shown that directives from the top to curtail lending are not as adhered to as the authorities would like.

In fact as an aside, those of us in the Western world probably view China as a country heavily directed from the top. This may be the case when it comes to human rights and the suppression of such, but when it comes to the business sector and the implementation of directives the gap between policy and practice can be extremely large. Either corruption gets in the way at the very local level, or the regional governments

simply pursue their own course maintaining what they consider to be a healthy distinction between their own mores and those of the ruling elite in Beijing. Sort of like the level of attention Invercargillites would pay to any suggestion from Aucklanders regarding how they should live their lives.

Throwing all these numbers in the pot it looks like inflation, monetary policy tightening, and rapid growth slowing worries will remain at the forefront of commodity and sharemarket minds for much of this year. Volatility is highly likely which will at times spill over into quick selling of commodity-dependent risky currencies such as the AUD and NZD.

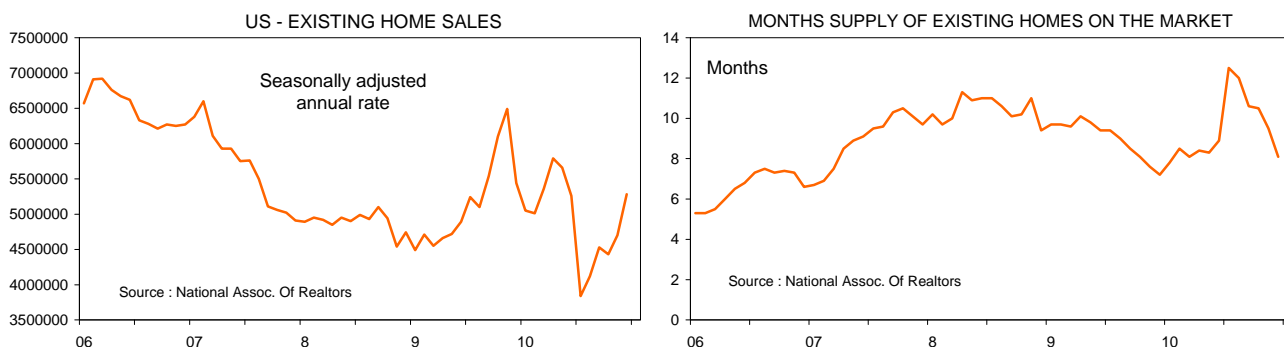
US Growth Momentum

The US economy has grown 2.2% over the past year but the upturn is not yet “self-sustaining” or reducing unemployment stuck above 9% at 14mn - worse than Germany, Japan, Britain and Russia. Manufacturing is firm but retailing, housing and business investment remain weak while few moves have yet been started to rein in an unsustainable Federal Budget deficit above 11% of GDP and concerns are growing about state and local budgets. What we’re looking for are signs that the economy is firing on more cylinders than just those caused by a low USD, restocking, and fiscal stimuli. I.E. consumption, housing, and business capital spending.

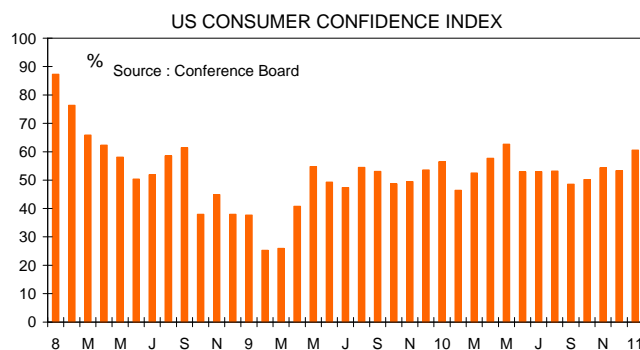
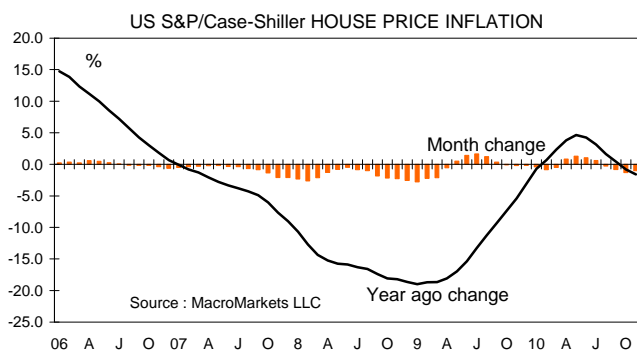
What’s new?

More and more positive sentiment is creeping to the fore with the labour market showing mild signs of life, manufacturing improving, and consumer sentiment rising. The sharemarket has risen well recently and it is expected the Fed. will print all of the extra US\$600bn they announced last year thus reinforcing the impact of the recent decision to extend tax cuts.

There are many housing market indicators in the United States and what we have been seeing for quite some time now is some going up and most going down. Things are basically bobbling along the bottom. This week we saw one of the former releases with sales of existing homes rising to an annualised pace of 5.28mn in December from 4.7mn in November and just 4.3mn in October. Activity has picked up a bit it seems. Prices however remain weak with the median price at \$168800 from \$170,200 in November and \$183,000 six months earlier in June. There remains 8.1 months worth of existing housing supply on the market which is actually ahead of 7.2 months a year ago though down from 12.5 months in July.



In fact according to the most accurate measure of house price changes in the US, the monthly S/P Case Schiller Index of 20 cities average prices fell for the fourth month in a row in November. Their main measure eased another 1% (or 0.5% seasonally adjusted) to lie 1.6% down from a year earlier, just 3.3% above the low seen in April 2009, and 30.4% down from the peak in July 2006.



But yet again, at the same time as data appear which are mild on the labour market and bad for the housing market by and large, consumer confidence continues to climb. The Conference Board measure of consumer sentiment rose to its highest level since May last year with a reading of 60.6 from 53.3 in December. The result points toward an acceleration in the rate of growth in economic activity even though in the very short term there is not a strong correlation between changes in consumer sentiment and changes in household spending. Stretched over a few months however the relationship is there.

Global Currency Conflict

Asian economies have driven growth for many years by keeping their currencies low against the greenback (thus hurting the purchasing power of their consumers). But their model of growth relying on excess spending by US households is shattered yet they either don't realize it or can't face the adjustment pain. Natural pressures on the greenback are now downward (budget and current account deficits, debt risk, relative interest rates and share of world economic activity and growth) but to stop their currencies appreciating versus the USD Asian economies are keeping their interest rates low and printing more money thus running rising inflation risks. Recent and planned extra US bond buying is adding to rising economic/political/trade tensions. We are watching for either Asian currency capitulation (most closely watched are the Chinese), further capital inflow restrictions, deployment of trade weapons, etc. The big risk is a global currency/trade war.

What's new?

This week was all about whether there would be any currency fireworks associated with the visit by the Chinese President Hu Jintao to the United States. As expected the Americans repeated their request that the Chinese stop interfering to keep their currency low and therefore keep the US trade deficit large as Americans find Chinese goods to be cheap. And as usual the Chinese President made it clear that currency adjustment is not just around the corner. So nothing special there to relax the tensions surrounding currency manipulation as economies around the planet seek either to devalue their currencies in order to maintain their reliance on US consumers to fuel their own growth, or they take measures to stem speculative capital flows which history shows can be quite destabilising when they go the other way – as happened for Asian economies in 1997/98.

Last week Brazil raised their cash rate 0.5% to 11.25% which is relevant to the discussion of currency disturbances because of the extra pressure the move is likely to place upon their currency the real. Further increases are expected. Contrast this with Turkey which in spite of inflation worries cut its interest rate 0.25% last week to 6.25%. Yet they are actually tightening monetary policy because reserve asset ratios for banks are being raised. The cut is intended to reduce upward pressure on the Turkish lira.

Brazil are also (according to rumours) going to try and improve their export prospects with a case to the World Trade Organisation challenging US subsidies for ethanol production. The thinking here is that the subsidies undercut returns from Brazil's own ethanol sales to the United States. Also the Brazilians look like they'll take a separate case against European beef trade restrictions introduced in 2008 – the aim obviously being to restore Brazil's beef sales in Europe. In addition an attack is planned against what are seen as subsidized exports of manufactured goods such as shoes from Asian countries which the Brazilians feel are really just shipping points for Chinese produce. The Chinese have to pay an anti-dumping tariff for their direct exports to Brazil.

Just for your guide, one estimate is that with the way China's inflation rate is going it will only be three years before the effect of current under-valuation of the yuan against the greenback is wiped out. That is, one way or another a country running a low currency strategy will pay a price either through a reduced standard of living for its citizens as imported goods are more expensive, or through higher inflation as is the case in China.

Just in case anyone here in New Zealand thinks that government actions outside of allowing a central bank to change its cash rate or a government to alter tax and spending are somehow frowned upon, this is not the case in most of the world. In their World Economic Outlook released this week the IMF for instance noted – in the context of emerging and developing countries facing capital inflows and rising inflationary pressures – “Macroeconomic policy responses may, however, need to be complemented by strengthened macroprudential measures (for example, higher loan-to-value ratios, funding composition restrictions) and, in some cases, capital controls.”

<http://www.imf.org/external/pubs/ft/weo/2011/update/01/pdf/0111.pdf>

Commodity Prices

Prices of commodities are soaring on the back of currently firm Asian growth, expected rising structural demand related to infrastructure and rising incomes, and surging speculative investor buying driven by US money printing, inflation fears, ultra-low interest rates, and wariness of alternative investments. Bubbles are undoubtedly developing but history shows we have zero chance of picking when they peak and where.

Oil prices eased following the reporting of higher than expected stocks in the United States. In addition the recent good data in the United States, strong industrial orders growth in the euro-zone, plus easing in concern about the European debt situation has seen some of the safe haven demand go out of commodity prices. Gold prices have hit a ten week low, oil is back near US\$86 a barrel, while the CRB Index is largely where it was a week ago.

In the emerging economies efforts continue to be made to try and stem the rise in food prices brought on by poor crops due to weather conditions in some parts of the world, the rundown of stocks previously built up, and simple rising demand due to population and income growth. Common measures include cutting tariffs on imported food, taxes on food exports, price controls, outright export bans, and country A calling on country B not to restrict their food exports.

The tricky thing with rising food prices is that often measures taken to control prices end up boosting them. For instance if farmers are prevented from raising their prices they lose the incentive to plant more and investors lose the incentive to develop new farm land. The big problem however is that the supply of food is relatively inelastic and so is demand. That means price changes can be violent – including on the downside if supplies do happen to respond strongly to either price signals the following season or simply the absence of bad growing conditions. What that means is that one should never blindly extrapolate food price changes into the future and those of us analysing inflation tend to strip food price changes out because periods of sharp rises/falls are more often than not followed by periods of sharp falls/rises.

Australian Growth

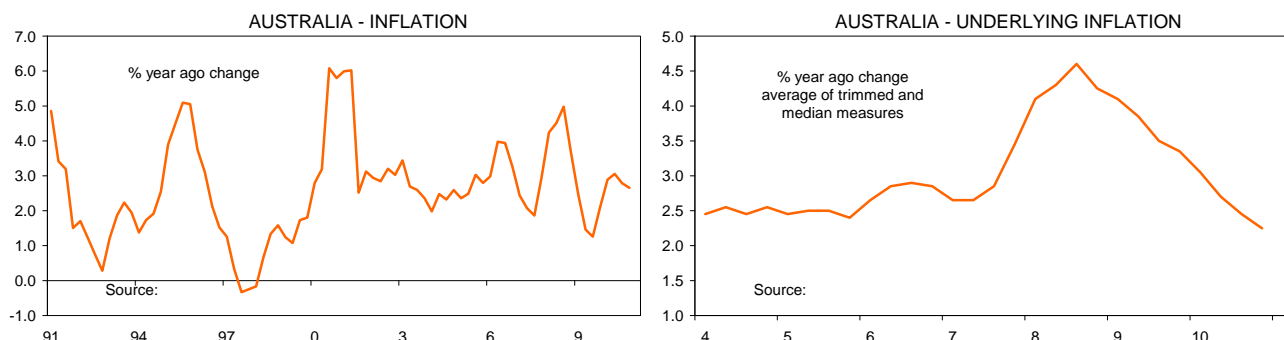
Australia delivers 24% of our merchandise export receipts, 45% of our tourists, owns almost all our banking sector and 51% of FDI, contains over 600,000 Kiwis and acts as a back-up labour market for most of us. What happens there matters to us so we shall monitor their growth here. The Aussie economy is growing strongly on a mining and infrastructure boom bringing us competitiveness advantages in tourism and manufacturing as the AUD soars but will drain our skilled labour base. There is an opportunity to entice manufacturers here. Jobs growth is averaging over 30,000 a month and at what point does this do four things – spur currently weak retail spending, spur appallingly low house construction, drive wage inflation, and spur higher non-mining business investment to boost productivity. The first three feed-throughs will accelerate monetary policy tightening and lower the NZD/AUD exchange rate further. If job growth accelerates migration outflows from NZ to Australia will soar even more than seems certain over 2011-12.

What's new?

The damages bill from flooding currently sits at AU\$30bn and the government is preparing people for the possible imposition of a special levy to help fund this expenditure while still allowing the Federal government

to quickly move its accounts back into surplus as a fast growing economy would suggest it should be doing. (If they don't then pressure on monetary policy is magnified and those exporters not enjoying high prices get hammered as the currency rises.)

The main piece of economic news this week was the December quarter consumers price index which rose by a less than expected 0.4% taking the annual inflation rate to 2.7% from 2.8% the previous quarter and 2.1% a year earlier. This is the third quarter in a row when the inflation result has surprised on the low side. What the RBA looks at are the underlying measures which strip out what will probably be short-lived price changes (fruit and vegetables, energy). Their weighted median measure rose just 0.5% in the quarter for the third quarter in a row while the trimmed mean measure rose only 0.3% with the average rate for these two compared with a year ago now at 2.3% which is lower than 2.5% in the September quarter and much lower than 3.4% a year earlier.



Because the inflation outcome was a good one the markets have become less worried about a short term interest rate rise so the Aussie dollar eased a tad and one imagines mortgage holders will feel slightly less worried about where their costs will be going in the near future. It is still widely expected that interest rates will be increased again this year as the economy's growth rate is going to receive a boost from rebuilding after the floods offset by some restraint on spending which one would expect to follow a flood levy if the Federal Government decides to introduce one.

Exchange Rates

Exchange Rates	This Week	Week Ago	4 wks ago	3 mths ago	Yr ago	Consensus Frcsts yr ago*	10 yr average
NZD/USD	0.771	0.765	0.747	0.749	0.71	0.690	0.629
NZD/AUD	0.775	0.767	0.744	0.759	0.786	0.772	0.855
NZD/JPY	63.300	62.800	61.950	60.930	63.6	66.999	68.4
NZD/GBP	0.485	0.479	0.484	0.472	0.439	0.426	0.368
NZD/EUR	0.562	0.568	0.570	0.540	0.503	0.495	0.511
NZDCNY	5.075	5.036	4.970	4.987	4.847		4.83
USD/JPY	82.101	82.092	82.921	81.403	89.577	97.100	109.9
USD/GBP	1.590	1.597	1.543	1.585	1.617	1.620	1.705
USD/EUR	1.372	1.347	1.311	1.386	1.412	1.394	1.229
AUD/USD	0.99	1.00	1.00	0.99	0.90	0.894	0.737

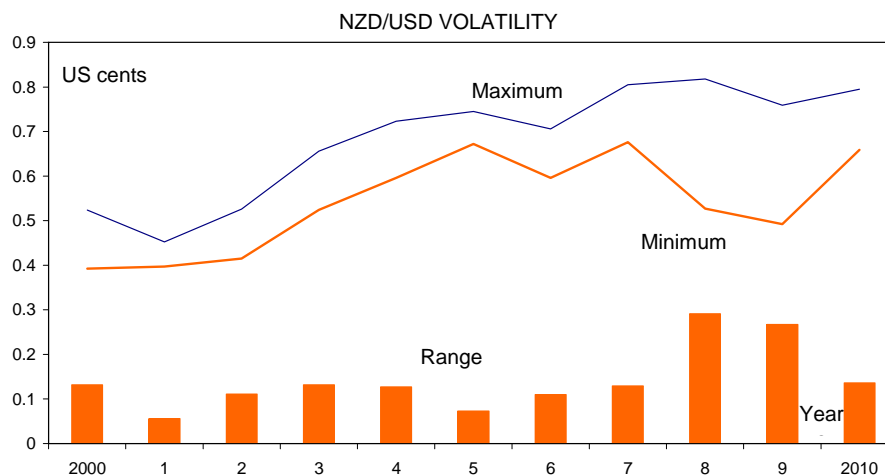
*Sourced from Consensus Economics. <http://www.consensuseconomics.com/>

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>

Just in case you have been feeling that the Kiwi dollar has been moving all over the place recently here is a graph showing the calendar year range against the USD since 2000. Things have been more volatile than usual over the past three years with the range averaging 23.1 cents compared with 10.9 cents over the

previous eight years. That's what having a global financial crisis can do and why many exporters will have found planning to be a nightmare over recent times.



The only substantial major currency movement this week has been that the Euro has had a strong week rising from \$1.347 last Thursday to just below \$1.37 largely on the back of increasing hopes that the European debt crisis has passed its worst point and things are now heading in the right direction. Hopefully this interpretation is correct. But very little has actually changed with regard to official handling of the problem. There is talk of strengthening the Stability Facility and cutting interest rates charged to Greece and Ireland but apart from that and good bidding by investors at auctions of some government debt there is little substance behind the confidence.

The Japanese Yen is where it was a week ago in spite of the Japanese government upgrading its outlook for growth this year. The British pound however was for a while slammed down on the back of fourth quarter GDP showing a fall of 0.5% rather than the rise of 0.5% which had been expected. Some of that shock could be put down to the effects of the snowstorms. But the upshot is that it is now going to be very difficult for the government to stay its course of massive fiscal cutbacks and so some of the debt risk associated with the pound has increased. The Aussie dollar has ended where it was a week ago against the USD, basically, like the pound, riding down with a weakening greenback with the impetus being the December quarter inflation number coming in lower than expected. That means less chance of an imminent interest rate increase and so some currency selling.

For the NZD we have ended the week up marginally against the greenback near 77.1, up a bit against a slightly weaker AUD, back above 63 against the yen (range trading there for a long time now), stronger against the poor old pound just above 48.5 pence, and down a tad against the stronger euro.

This morning's review of the official cash rate by the Reserve Bank was exactly as expected so there was no impact on the NZD.

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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	2.3%	1.2	4.0	2.0	3.4
GDP growth	Average past 10 years = 2.6%	-0.2	0.1	+1.4	-2.5	1.5
Unemployment rate	Average past 10 years = 4.7%	6.4	6.9	6.5	4.3
Jobs growth	Average past 10 years = 2.0%	1.0	-0.2	1.8	-1.8	1.1
Current a/c deficit	Average past 10 years = 5.9% of GDP	3.1	3.0	3.2	8.6
Terms of Trade		2.0	5.8	12.7	-13.5	10.7
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%.	0.9	0.9	1.9	-0.9	0.4
House Prices	REINZ Stratified Index	0.0	-1.2	-2.3	6.0	-7.9
Net migration gain	Av. gain past 10 years = 13,900	+11,519	14,507yr	20,021	3,569
Tourism – an. av grth	10 year average growth = 3.2%. Stats NZ	3.4	4.4	3.4	-0.6	-0.6
Consumer Conf.	Neutral = 100	108.3	114.1		116.9	101.3
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Business confidence	BNZ survey	18	28	26	43	-6
Household debt	10 year average growth = 10.3%. RBNZ	1.8	2.0	2.6	2.9	5.0
Dwelling sales	10 year average growth = 2.5%. REINZ	-11.3	-15.2	-24.3	15.2	-23.1
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 Dec. 2 2010	March Years					December Years				
	2009	2010	2011	2012	2013	2008	2009	2010	2011	2012
GDP - annual average % change										
Private Consumption	-1.2	0.6	1.5	1.7	1.4	-0.4	-0.6	1.9	1.5	1.5
Government Consumption	4.3	1.1	2.3	1.4	0.9	5	1.4	2.7	1.1	1.2
Investment	-7.1	-9.7	4.7	5.2	6.9	-3.5	-12	2.5	4.5	7.5
GNE	-1.5	-3.3	2.4	3.8	2.6	0.4	-5.1	2.7	3.1	3.1
Exports	-3	3.2	2.5	5.4	2.3	-1.1	0.4	3.2	4.8	2.9
Imports	-4.3	-9.5	5.8	4.2	4.7	2.3	-14.8	6.8	3.4	5.3
GDP	-1.5	-0.4	2	4.1	1.7	-0.2	-1.7	1.9	3.6	2.3
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	1.5	2.6	0.9	0.9	-2.4	2	2.9	0.7
Unemployment Rate %	5.1	6	6.3	5.5	5.7	4.6	7.1	6.4	5.5	5.7
Wages	5.1	1.6	3	3.8	4.6	5	3.1	1.9	3.4	4.6
Currently reasonable exchange rate ASSUMPTIONS										
NZD/USD	0.53	0.7	0.78	0.74	0.64	0.56	0.72	0.76	0.76	0.67
USD/JPY	98	91	85	89	85	91	90	84	88	86
EUR/USD	1.31	1.36	1.35	1.42	1.34	1.34	1.46	1.32	1.4	1.36
NZD/AUD	0.8	0.77	0.78	0.8	0.82	0.83	0.79	0.78	0.8	0.82
NZD/GBP	0.37	0.47	0.48	0.44	0.39	0.37	0.44	0.48	0.45	0.4
NZD/EUR	0.41	0.52	0.58	0.52	0.48	0.41	0.49	0.58	0.54	0.49
NZD/YEN	51.8	63.7	66.3	65.9	54.4	50.9	64.2	63.8	66.9	57.6
TWI	53.8	65.1	70	67	60.9	55.1	64.7	68.9	68.5	62.7
Official Cash Rate	3	2.5	3.25	5	4.75	5	2.5	3	4.75	5
90 Day Bank Bill Rate	3.24	2.67	3.57	5.15	4.9	5.23	2.78	3.2	5.07	5.15
10 year Govt. Bond	4.77	5.86	5.7	6.5	6.5	4.88	6.02	5.6	6.25	6.5

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