BNZ Weekly Overview

28 January 2010

Mission Statement

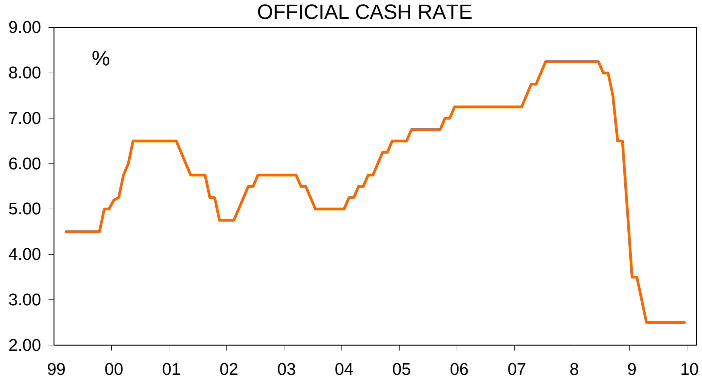
To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

In this week's issue….

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.

Interest Rates Steady

The main point of interest with regard to the NZ economy this week was the Reserve Bank's review of the official cash rate this morning. As had been practically universally expected the rate was left at the record low of 2.5% reached in April last year when the RB was responding to the dire downturn in world growth. The rate had peaked at 8.25% in July 2007 and reductions from that level started in July 2008 as the RB responded to the NZ recession then underway – and with an eye toward the worsening situation offshore.



Last year, when giving an indication as to how long they would keep the cash rate at 2.5%, the RB started out by indicating the "latter part" of 2010. That changed in October to "the second half" of 2010, and then in early December they shifted to "the middle" of 2010. The fact that they changed their outlook quite a bit in the space of just three months is no major problem as most people were being surprised in the second half of last year by the rebound in world growth prospects and our own economic outlook.

This morning they maintained their indication of the middle of the year and we retain our long held view that the removal of the stimulatory 2.5% rate level will commence probably in June. The markets are still pricing in the RB moving a tad sooner than that and it is possible they could move early as each week we learn a bit more about how robust the world outlook is and how we are faring here.

With respect to recently released data there is nothing to suggest that having a view of slowly improving growth this year will turn out incorrect. Business and consumer confidence levels are high and business investment and hiring intentions are close to average levels.

Householders are increasing their retail spending and house construction is picking up quite well. Commodity prices have recovered over 40% since early last year and exporters have been spared some pain recently with the NZD failing to continue its run up which occurred between March and October and instead settling back for now closer to US 71 cents than 76 cents. The currency also remains slightly below average against an Aussie dollar well supported by continuing strong data appearing across the Tasman.

But there is nothing to suggest growth is going to get overly strong in the near future.

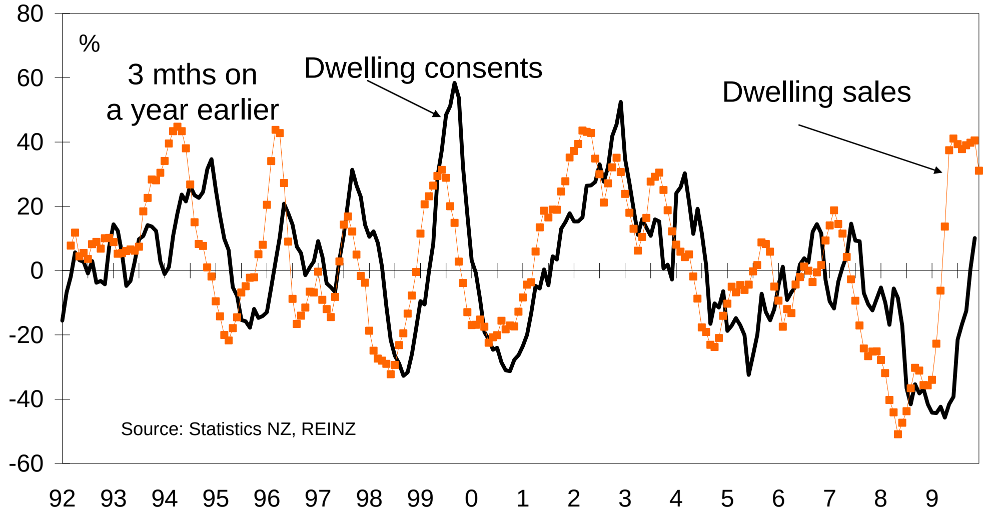
Although interest rates are low householders are reluctant to take on more debt. The annual rate of growth in household debt was just 2.7% in December with seasonally adjusted debt growth of only 0.2% a month recently. Consumer debt – credit cards, HP etc – has actually fallen 5% in the past year. And for what it is worth, credit card spending fell seasonally adjusted 1.3% in December after rising 0.8% in November and only 0.1% in October. There is a retailing recovery underway best seen in the monthly retail numbers. But we think there are temporary elements of catch-up spending there which suggests while it is reasonable for retailers to anticipate a good year overall in 2010, it would be very silly to speak of high strength.

Businesses are indicating they plan hiring people, but the strength of the hiring upturn will be muted initially as people placed on reduced hours have their hours restored to where they were. Only after that will generally possibly firm jobs growth come and that may not happen until 2011.

We banks can safely say that while there are many businesses thinking about investment and saying they plan doing it in surveys, demand for credit to finance such growth is still relatively muted. Business debt was 7.2% lower in December than a year earlier (deleveraging at work). This is one way in which this year could become quite "interesting". Once business credit demand does pick up more borrowers will learn about the reduced availability of credit brought on by the aftermath of the global financial crisis.

Finally, in this brief list of reasons why high optimism should be contained, dwelling sales have decreased recently and there is a good correlation between changes in dwelling sales and changes in dwelling consents. The recent easing of sales suggests that while consent numbers are still highly likely to move upward, the speed is likely to slow from the strong seasonally adjusted gain of 20% recorded for the three months to November. Note that the graph below does not yet capture this decline in dwelling sales.

DWELLING SALES AND DWELLING CONSENTS



Overall, we expect 2010 to be better than last year (one is hardly going out on a limb with that view), but there will be occasional headwinds. The highlight hopefully could be the Budget if the Government has the nerve to do what needs to be done with regard to personal income tax rates and GST.

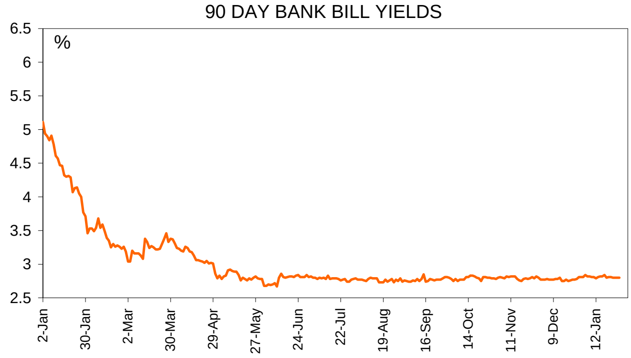
INTEREST RATES

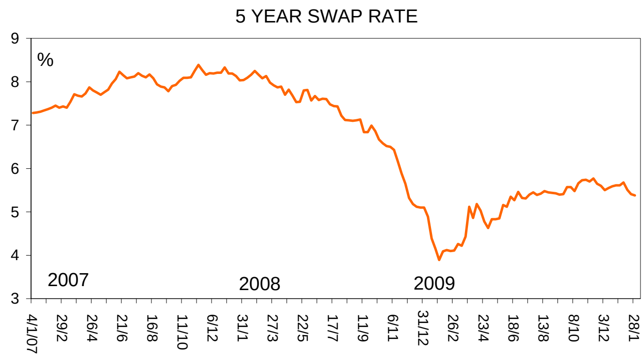
The Reserve Bank met expectations this morning by leaving the official cash rate unchanged at 2.5% and retained their guidance of tightening starting in the middle of the year. A key question is how fast they will raise the cash rate. This is quite difficult to figure out because at the best of times one is making best guesses about how businesses, consumers, the exchange rate etc. will react as interest rates change. If the reaction is strong rate rises may be limited in timing and magnitude. But if we all just shrug our shoulders and largely ignore rising rates – as happened from 2004 – 2006 then rates may have to either rise fast (as they should have back then) or go to a high level.

At this stage our expectation is that the RB will raise the rate 0.25% at the meeting on June 10 then increase 0.25% each meeting after that until the rate reaches somewhere close to 6% in 2012. That means the 2.5% rate could be at 3.5% come the end of this year so floating mortgages rate will be up about 1%. If steady rises continue the rate will then reach 5.5% at the end of 2011 so the likes of our Total Money floating rate will then be around 8.5% - 9%.

It has to be said however that the chances are the pattern of rate rises will not be steady and the RB will possibly throw in the occasional 0.5% rate rise if the economy is looking quite strong, or pause for a while if they want to see what the impact of rate rises will be.

Given the announcement this morning was as expected 90-day bank bill yields remain at 2.8% while swap rates have edged a tad lower from a week ago as a few more hawks expecting an imminent rate rise pull back their positions.





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	5.00	6.2
90-day bank bill	2.80%	2.81	2.81	2.80	4.00	6.5
10 year govt. bond	5.91%	5.85	6.07	5.80	4.25	6.2
1 year swap	3.65%	3.68	3.71	3.55	3.15	6.7
5 year swap	5.38%	5.41	5.61	5.74	3.89	7.0

If I Were a Borrower What Would I Do?

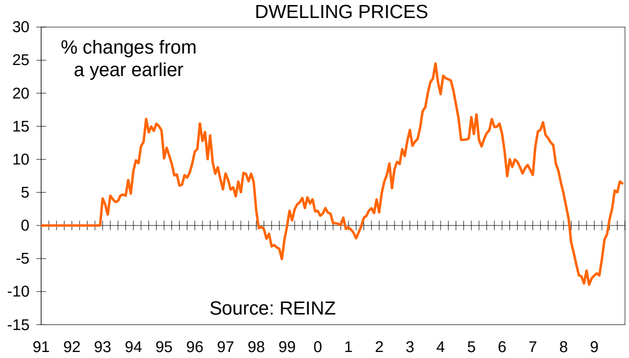
Float – nothing new to add onto last week's comments.

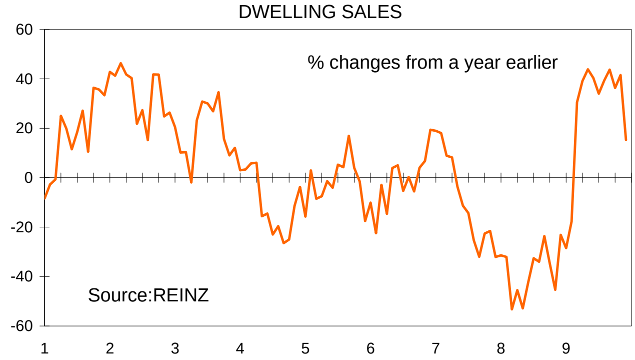
HOUSING MARKET UPDATE

House Price Rises Confirmed - Again

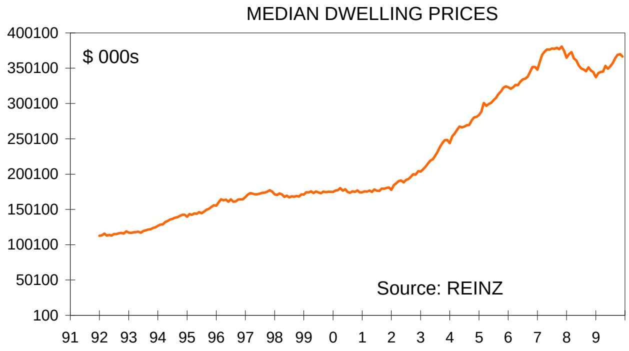
Quotable Value NZ this week belatedly confirmed what we learnt a long time about house prices during the September quarter – they rose. The data released by REINZ three months ago show prices on average rose by 2.5% in the quarter. The QVNZ data show they rose 2.2%. The REINZ series then was 2.9% ahead of a year earlier and the QVNZ series 1.1%.

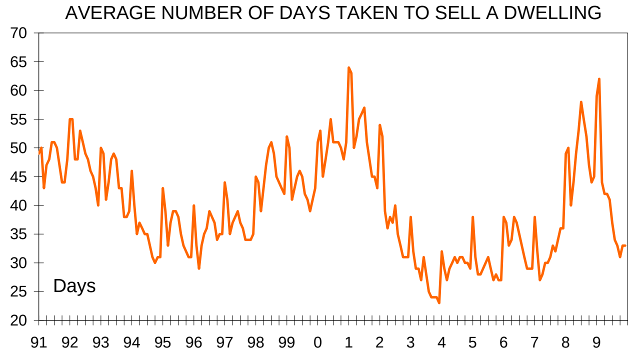
The QVNZ data are vital for good historical analysis and provide really good regional breakdowns. But from a nationwide point of view we already have information three months more up to date than what they have released so there is nothing more to add here than to note the REINZ series rose another firm 2.8% in the December quarter – but with prices easing 0.9% in the month of December and rising just 0.2% in November. Things have cooled down for now and could easily stay that way until we get clarification on the way in which investors will be hit by tax changes.





This week we have received no fresh data on the state of the housing market in New Zealand and have nothing to add beyond that which we wrote last week. But for your guide, perhaps one thing it would be useful to try and figure out is how many investors might sell their investment property or not buy one if the tax rules are changed. Given that we don't know what changes are coming this is of course impossible to figure out. Good luck.





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

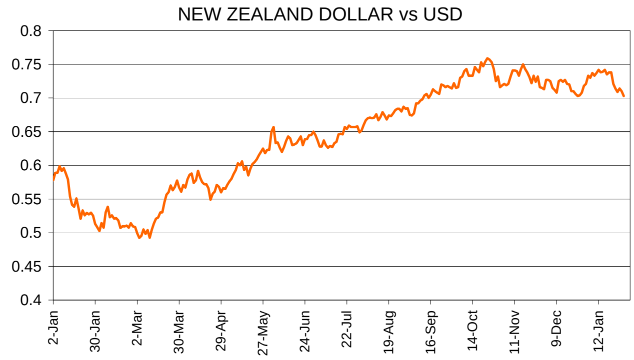
- Dwelling consent numbers to recover now with potentially good activity from mid-2010.
- Real estate sales continuing to increase but the rise limited by listings shortages.
- House prices edging higher subject to tax changes bringing short term downward pressure.

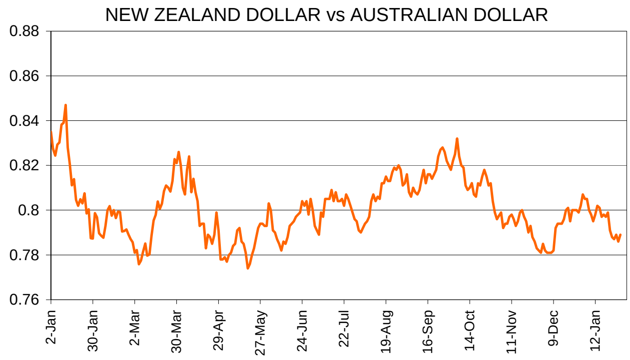
Exchange Rates & Foreign Economies

Exchange Rates	This Week	Week Ago	4 wks ago	3 mths ago	Yr ago	Consensus Frcsts yr ago*	10 yr average
NZD/USD	0.707	0.721	0.708	0.743	0.5298	0.573	0.592
NZD/AUD	0.788	0.791	0.799	0.812	0.8004	0.848	0.856
NZD/JPY	63.60	65.800	64.900	68.200	47.12	59.0	66.8
NZD/GBP	0.437	0.443	0.443	0.453	0.3745	0.358	0.345
NZD/EUR	0.503	0.511	0.493	0.502	0.4022	0.448	0.51
USD/JPY	89.96	91.262	91.667	91.790	88.939	103.0	113.9
USD/GBP	1.618	1.628	1.598	1.640	1.415	1.601	1.709
USD/EUR	1.406	1.411	1.436	1.480	1.317	1.278	1.156
AUD/USD	0.897	0.912	0.886	0.915	0.662	0.676	0.69

NZD Falls Below US701 cents

It has been a good week for exporters with the NZD this evening near US70.7 cents compared with 72.1 cents a week ago and a peak near 76 cents back in October. The NZD has fallen almost four cents over the past fortnight – not because of any change in interest rate expectations, NZ growth forecasts, or commodity prices. Instead the NZD has been dragged lower by a bounce up in worries about the global economy and a decent bout of profit-taking sweeping through sharemarkets and causing the Dow Jones Index to fall to 10,236 last night from 10,907 two weeks ago. Growth and sharemarket worries correlate with reduced risk tolerance and that means reduced willingness to buy currencies of high yielding far flung economies running large current account deficits – us



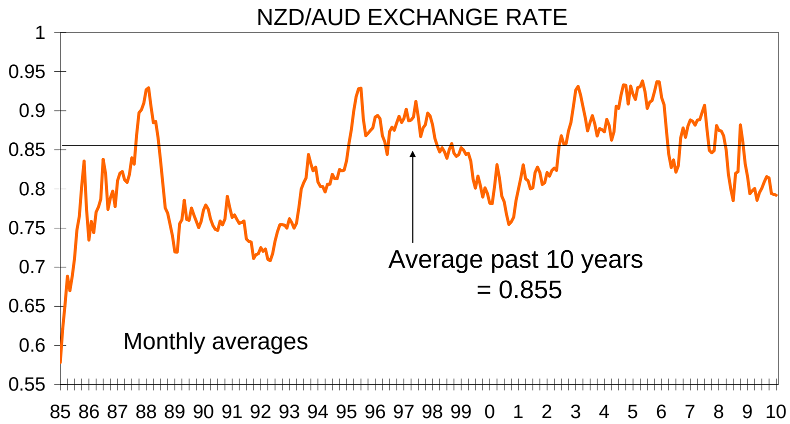


Will the NZD stay down? Only if global growth worries remain and we don't think they will. On the world scene there remains underlying optimism that things are heading in the right direction with regard to improving growth. But barely a sole sees anything other than ongoing problems which will cap the strength of the recovery. As we have seen for many months now, at the same time as data are released showing things like improving house prices in the US and UK, other data appear showing debt worries are restraining the willingness of banks to lend and the willingness of households and businesses to borrow.

Over this year and probably next we are highly likely to see this pattern continuing with the occasional flare up of concern causing sharemarkets to weaken and our risky currency to also fall away - but with trends in growth, sharemarkets and our currency likely to remain broadly upward.

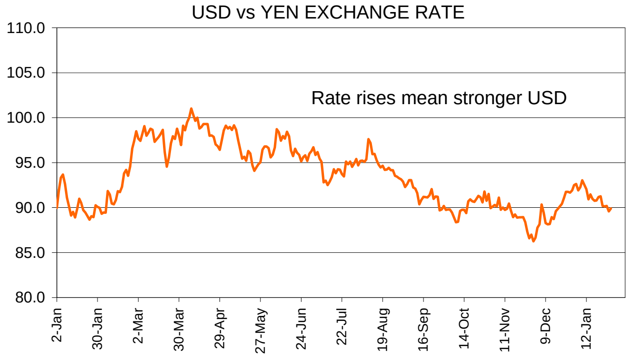
With regard to the current bout of reduced risk tolerance, worries have increased regarding how sustainable China's recovery is in the face of obvious inflationary pressures in the property market and the potentially ham-fisted way the authorities will attempt to restrict these pressures through bank lending controls. In Japan worries have increased about the fiscal outlook following Standard and Poor's decision to change their credit rating outlook from stable to negative. In Europe concern remains about how to handle the problem with Greece's financial accounts – or more specifically the obvious economic weakness which must be induced in that economy to restore fiscal rectitude and keep Greece within the Euro zone.

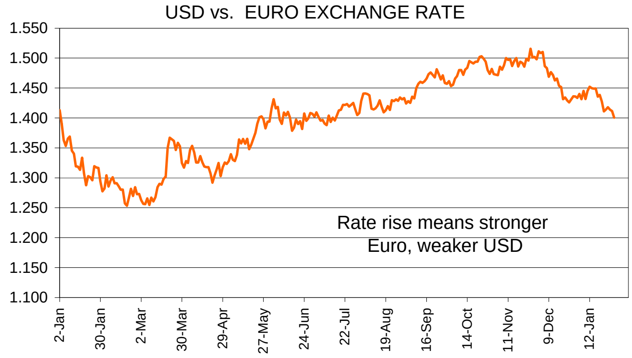
At least for ourselves Australia's economy continues to chug along at good pace with many positive data surprises. And one good aspect of the Aussie economy's growth on top of better demand for our manufactured exports and tourist inflows is that the continuing tightening of monetary policy could see the NZD weaken against the AUD. It seems extremely unlikely that this currency cycle the NZD will reach its traditional peak against the AUD near 94 cents.



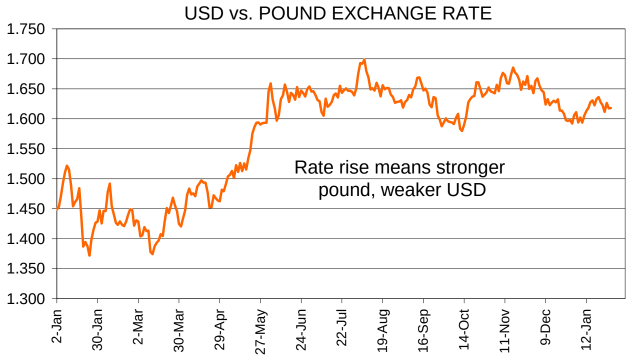
Speaking of policy tightening. Next week the Reserve Bank of Australia are highly likely to increase their cash rate from the current 3.75% to 4%. It was 3% at the start of October. Our rate is 2.5% and not likely to rise until the middle of the year – as indicated again by the RBNZ in their regular six – weekly review of the cash rate this morning.

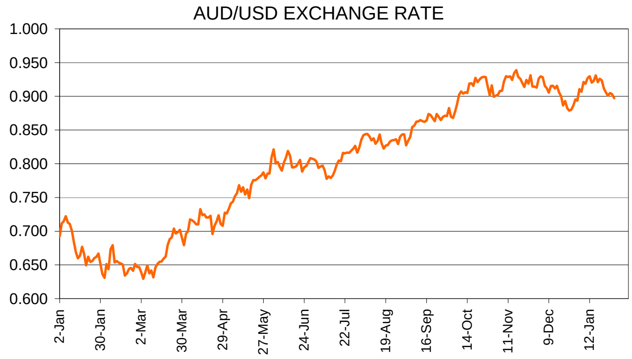
Looking at the major currencies now. The greenback has ended the week against the Japanese Yen weaker near 90 from 91.3 last week. Is this move significant in terms of currency trends? Not at all. As the first graph below shows the USD/JPY exchange rate has been relatively directionless since September and it would for the moment to be a brave call to look at the graph showing the rate declining from March and conclude the greenback will continue to weaken through the year by all that much against the Yen.





Against the Euro the USD has however strengthened to near $1.406 from $1.411 assisted by the Euro being affected by worries about Greece and Spain. Against the Pound the USD has also strengthened a tad to $1.618 from $1.628.





The Aussie dollar has weakened against the USD over the week to hit a four week low of 89.7 cents from 91.2 cents last week. This weakness mainly reflects reduced risk tolerance associated with the worries mentioned above for some large economies.

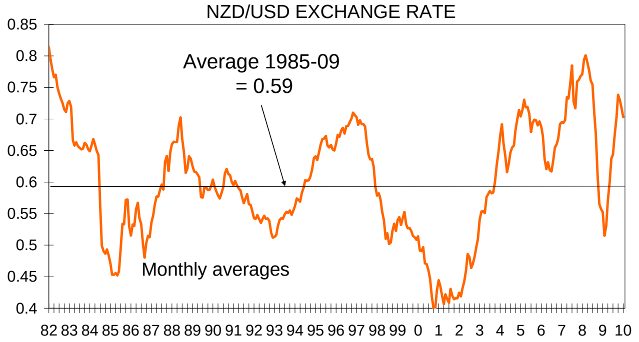
If I Were An FX Receiver What Would I Do?

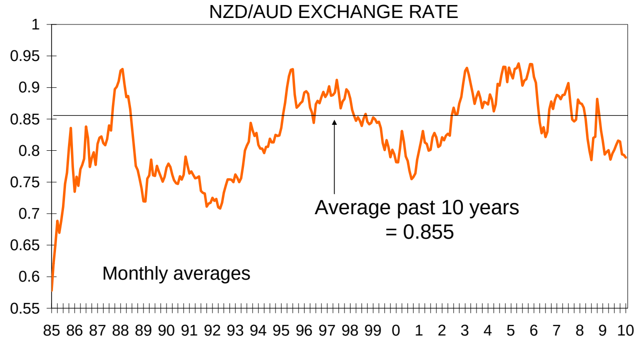
Easy. Take advantage of dips in the NZD to get extra 12-18 month hedging in place against other currencies. Our expectation is that the NZD will rise this year on the back of improving economic growth, tightening monetary policy, well supported and perhaps still rising commodity prices, and improving global risk tolerance. But while in normal times frankly one considers exchange rates to be unforecastable, these times remain far from normal and there are big questions about economic fundamentals behind each of the major currencies – the greenback, Yen, Euro and British pound.

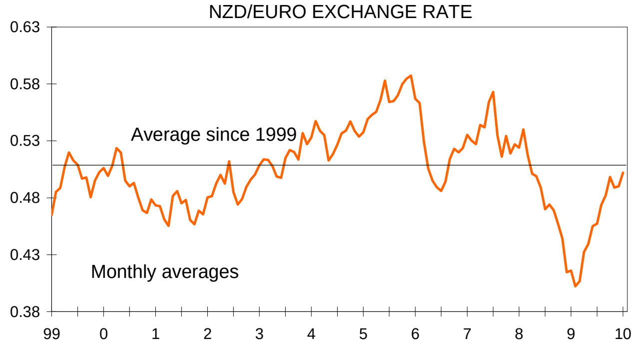
A large area of uncertainty is what will happen to the greenback when the Federal Reserve starts tightening US monetary policy. Will rates rise more quickly than in other countries? Will Japanese investors jump out of the zero yielding Yen for better yielding USDs if they remain still too wary to fully embrace the likes of the higher yielding NZD. Will the Fed. be able to raise rates in an “optimal” way which contains inflation further out without crimping short term growth as debt servicing costs rise for US consumers, businesses, and of course the Federal Government. Good luck picking one’s way through that and all the other post-global financial crisis problems.

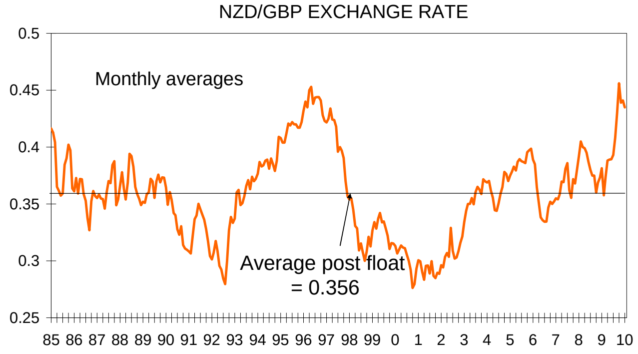
For your guide, following their two day meeting this morning the Federal reserve Board released a statement noting that economic conditions are "likely to warrant exceptionally low levels of the federal funds rate for an extended period."

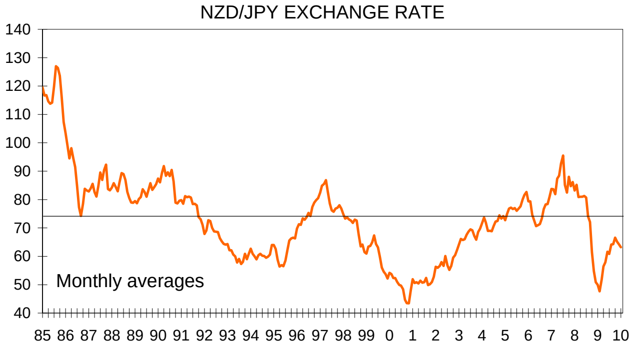
For ourselves the broad view we feel is reasonable is that the NZD will strengthen this year toward US 80 cents with lesser rises against other currencies, but at some stage the NZD will correct downward as investors regain confidence in the USD (assuming they do). That NZD drop may come next year.

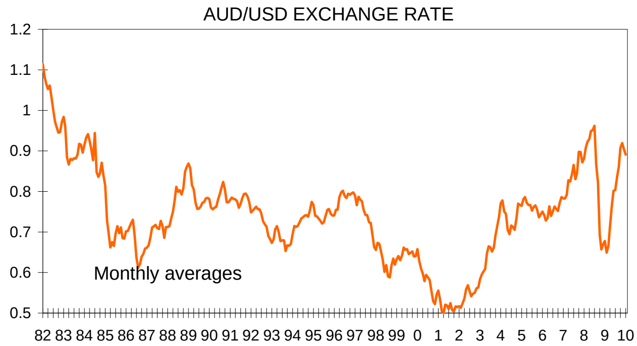












*Sourced from Consensus Economics. http://www.consensuseconomics.com/

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%	6.5	6.0	......	4.3	3.6
Jobs growth	Average past 10 years = 1.9%	-0.7	-0.4	-1.8	1.1	1.6
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	0.6	0.8	4.6	5.6	4.6
Retail Sales ex-auto	Average past 9 years = 3.8%.	0.5	0.3	-0.9	0.4	5.5
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	+20,021	15,642yr	......	3,569	6,590
Tourism – an. av grth	10 year average growth = 5.0%. Stats NZ	-0.6	-2.8	-0.6	-0.6	2.4
		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	37	34	26	-22	18
Household debt	10 year average growth = 11.3%. RBNZ	2.8	2.6	2.6	4.9	12.9
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 Dec. 10 2009	**March Years**					**December Years**				
	2008	2009	2010	2011	2012	2007	2008	2009	2010	2011
GDP - annual average % change										
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	-11.7	5.7	8.8	4.9	-5.2	-14	2	9.6
GNE	4.2	-2	-3.4	4.2	3.5	4.4	-0.1	-5	3.6	3.7
Exports	3.1	-3.3	1.3	0.6	5	3.9	-1.3	-0.5	0	4.8
Imports	10	-4.7	-12.4	3.8	5.9	8.9	2	-16.3	2.6	5.6
GDP	3.1	-1.1	-0.6	3.1	3.1	3.2	0	-1.5	2.5	3.4
Inflation – Consumers Price Index	3.4	3	2.6	1.2	2.6	3.2	3.4	2.5	1.7	2.1
Employment	-0.2	0.7	-1.5	2.6	3.2	2.4	0.9	-2.8	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	4.3	5.1	3.4	1.6	3.8	4	5	4.1	1.4	3.3
EXCHANGE RATE ASSUMPTIONS										
NZD/USD	0.8	0.53	0.77	0.77	0.7	0.77	0.56	0.75	0.78	0.72
USD/JPY	101	98	92	105	109	112	91	91	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	0.81	0.83	0.82	0.88	0.83	0.81	0.82	0.83
NZD/GBP	0.4	0.37	0.46	0.44	0.41	0.38	0.37	0.45	0.44	0.42
NZD/EUR	0.52	0.41	0.52	0.53	0.5	0.53	0.41	0.5	0.54	0.51
NZD/YEN	81.1	51.8	70.8	80.9	76.3	86.3	50.9	68.3	81.1	77.8
TWI	71.6	53.8	68.9	71.4	67.2	71.6	55.1	67.2	71.8	68.5
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	2.75	4.62	6.62	8.9	5.23	2.8	4.17	6.12
10 year Govt. Bond	6.36	4.77	5.8	6.3	7	6.4	4.88	5.75	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