BNZ Weekly Overview

6 January 2011

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.

Global Growth Expected

Welcome back everybody to the second year in a row when we and economists in other countries have generally optimistic expectations for how our economies will perform. Last year our optimism turned out to be slightly though not excessively out of place with early upturns slammed by the European debt crisis and both businesses and households in Western economies wanting to get their debt levels down (curb spending) by more than we had assumed.

This year the general theme for the planet is continuing strong growth in emerging economies which will be good for commodity exporters like us, with extra upward pressure on those prices from investors chasing each other's tails in a world awash with money printed by the US Federal Reserve. In the United States growth around 2.7% is commonly forecast from 2.2% in the full year to September with recent data showing strength in the labour market and retailing but housing heading into a double dip recession while exports and manufacturing remain firm. Business capital spending remains a weak point and there are huge risks associated not just with the record Federal debt but state and local debt levels. The ride will likely remain bumpy.

In Europe growth for all 27 of about 1.6% is expected led by Germany which is doing well after ten years of economic rectitude. But debt problems for Ireland, Greece, Portugal and Spain remain huge and further market turbulence is virtually guaranteed on the way to eventual debt restructuring for some of these countries. Massive fiscal tightening will continue bringing more people onto the streets making interesting reading for those of us down here who migrated away from all that silly behaviour, squashed housing, appalling weather, and old boys clubs sometime in the past couple of hundred years.

The Chinese economy is forecast to grow strongly but faces a worsening inflation issue with property bubbles and the big question is whether inflation can be brought back down from 5.1% without slashing growth. Again, as with European debt and the US economy's momentum and debt debates, this factor will generate at times large volatility in financial asset prices around the globe.

Australia's economy is forecast to grow by about 3.2% underpinned by mining and infrastructure but with a close eye being kept out for signs of any improvement in still weak retailing, housing and business capital expenditure. The labour market is very tight and will draw our skilled people away but the exchange rate should bode well for our manufacturing and tourism sectors.

As for us, there are many factors suggesting we are likely to grow around 3% this year with what we think will be some rapid labour market tightening as the year progresses and potentially strong debate late in the year regarding lack of housing construction with that awareness helping to contribute to a turnover, construction, and price recovery from sometime in the second half. Our economy will get help from record and still rising export commodity prices, the Rugby World Cup, rebuilding of Christchurch, growing debt comfort for some spurring willingness to spend, and cost pressures bringing greater business capital spending.

Restraint however will come from fiscal tightening likely to be announced in the May Budget, continuing underlying debt intolerance, structurally lower credit availability, and the usual long running factors. These include our distance from markets raising transport costs, limiting import competition for inefficient domestic operators, curtailing efficiencies of scale and ability to specialise, limiting foreign direct investment and technology diffusion, and curbing person to person interaction so vital to idea generation, product development and capital raising. Plus the ongoing migration-driven population churn will see the go-getters go and those coming in smiling happily as they hug the trees. Then there are the high per capita infrastructure costs, high government ownership of assets (transport and energy in particular), and inefficiencies associated with the zero interest student loan scheme, Working for Families welfare scheme, etc.

The NZD is likely to be extremely well supported against the dodgy British Pound and Euro by our high export prices and monetary policy tightening maybe in the middle of the year all going well. Against the greenback things depend substantially on what happens in the US economy, attitudes toward and actual changes in the role of the greenback as a global reserve currency and the path of the US debt debate. One suspects a move toward 80 cents before NZD depreciation sets in once US monetary policy tightening kicks up one day.

Against the Aussie dollar we are likely to remain weak while against the Yen nothing startling jumps out to suggest a big move up or down.

But that is stuff for the future and the thing about expectations for what will happen is that those expectations almost always change as we learn more. More than that, as anyone who goes tramping knows, having the best navigational skills involving map and compass is useless if you can't first of all figure out where you are. And that dear readers is where by and large we have sucked over the past year. Most of us have continually portrayed the economy as being in better shape than it actually was. Our analysis of monthly and even quarterly data has told us some stuff about where we are but then we have quickly bypassed it and waffled on about what the sentiment surveys show and how big factors will eventually shine through.

So what we are going to do here to try and combat that tendency to downplay actual data on our current condition is introduce a new section to the Weekly Overview titled Is Our Economy Getting Better or Worse?

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.

Our analysis suggests we are barely growing with house building, non-residential construction, real estate and finance in or close to recession, exports flat, retailing growing very very slowly perhaps along with business capital expenditure, and manufacturing improving.

Are householders opening their wallets more?

There is no evidence of this. Christmas retailing was weak according to company comments and electronic transaction data, and core spending growth was a lowly annualised 2.5% in the three months to October versus an average growth rate for the past 15 years of 4.7%. Three months ago this reading was 6.4% so things have deteriorated late in 2010. Car registration data have improved recently but fleet purchase fluctuations and rental company rebuilding in particular could account for this rather than higher household spending. Core electronic card spending rose at an annualised rate of 7.8% in the three months to November from 5.2% three months earlier and average growth since 2004 of 5.9%. November month growth was 1% which followed October's post-GST 0.1% gain. The result is not bad but merely confirms to us that retail spending is growing but growth is weak and almost certainly not accelerating.

Is business output rising?

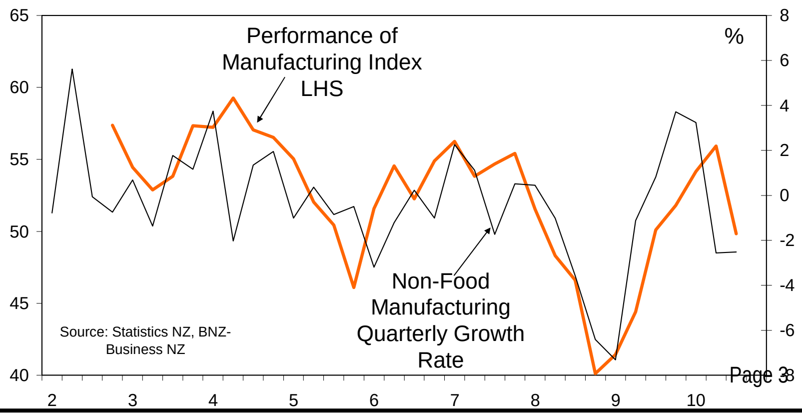
Oh man. Answering this for our economy is a nightmare. We have no monthly or even quarterly industrial production series and in case you haven't noticed the notes you might read regarding quarterly output from the manufacturing sector, concrete production, construction work put in place etc. all relate to their input into the next GDP number which when it eventually appears on average refers to a period four months in the past.

With regard to up to date stuff all we have is the monthly construction consents data we can use to guesstimate whether builders are busier or not, the monthly BNZ-Business New Zealand manufacturing survey which may or may not correlate with actual manufacturing output changes, export data, plus real estate and lending aggregates for deriving rough and ready measures. Other releases are all quarterly.

In the 12 months to October the value of consents issued for non-residential buildings amounted to $3.7bn which was the lowest total since the start of 2005. In the three month period the total was $933mn which was down 4% from a year earlier. The commercial construction sector appears to be shrinking but the rate of decline is close to plateauing. Lags between consent issuance and construction are highly variable however but given the drift down in consents over the past two years it seems fair to conclude that construction is at the moment declining.

Issuance of consents for dwellings were down a seasonally adjusted 16% in the three months to October and 2.9% in the three months to July. House building is in recession.

The BNZ-Business NZ Performance of Manufacturing Index improved to 52.7 in November from 50 in October where a level of 50 means no improvement or deterioration. The average for this measure is 52.5 so growth is at best average. But more realistically, over the past six months this measure has averaged 51.3, three months 50.8, and it was at 49.5 in August and 58.2 in April. The best one can really say is that there is a recovery following a plunge in growth mid-year but growth at best is average and looking volatile. Also,



on a monthly basis the measure gives little information on what is really happening with manufacturing output because even on a quarterly basis the correlation is sometimes leading, sometimes lagging, and sometimes coincident with actual non-food manufacturing production.

The value of merchandise exports in the three months to October was up 17% from a year ago but down roughly 2% in seasonally adjusted terms from the three months to July. The trend rate of monthly growth in export receipts has slowed to only 0.1% from 0.3% in September, and an average of a strong 1.6% a month for the first eight months of the year. Growth has been strong but recently it has faded and could be zero.

Our monthly BNZ Confidence Survey in early December produced far more comments of activity being weak than strong at the moment in respondent industries.

Taken as a proxy for finance sector output, lending volumes are static therefore output in the banking sector is static. On average private sector credit has grown by 9% per annum in the past ten years. It grew just 0.4% in November from a year ago. In rough seasonally adjusted terms lending to the private sector fell 0.4% in November and has fallen every month since September 2008. We are deleveraging.

So, retailers are struggling, construction is shrinking along perhaps with exports and the real estate sector but manufacturing is growing while for agriculture – well weather is making that estimation very difficult. One would have to say that the fictional average NZ business is experiencing only very weak growth.

Are businesses hiring more people?

Yes. Job numbers have risen 0.5% on average for the past four quarters with growth of 1% in the September quarter. Hours worked have improved on average 0.3% a quarter and 0.6% in the September quarter. But these numbers are old. Do we have anything on a monthly basis we can use? Only comments from respondents in our monthly survey and I am trying to find what I think is a series that has been put out in the past by TradeMe.

Are businesses boosting their capital spending?

We have no monthly measure of this, just quarterly data in the national accounts which are always well out of date. We can only make some guesses using import, lending, and vehicle registration data. These measures suggest there is growth in business capital expenditure.

In the three months to October the value of imports of machinery and plant was ahead 18% from a year ago or 21% adjusting for exchange rate changes. The three month cost of these imports was $1.7bn which was ahead from a six year low of $1.23mn in the March quarter. Businesses appear to be investing more. But if so then they may be financing the spending through retained earnings as lending to the farming and urban business sectors combined stood at $120.1bn at the end of November which was down 3.2% from a year ago and ahead only 0.3% from three months earlier whereas on average over the past ten years growth over this period of time has been 3%. Still, this measure was negative from early 2009 therefore there may be a lift in lending to the business and farming sectors underway.

Registrations for commercial motor vehicles in the three months to November were ahead 6.6% from a year ago but down 5% from the three months to August roughly seasonally adjusted. Spending in this area appears to be pulling back.

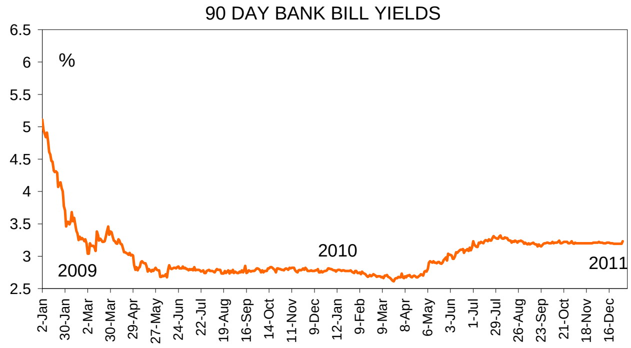
We think there is business capital spending growth underway but data do not allow us to conclude if this growth is strong or weak.

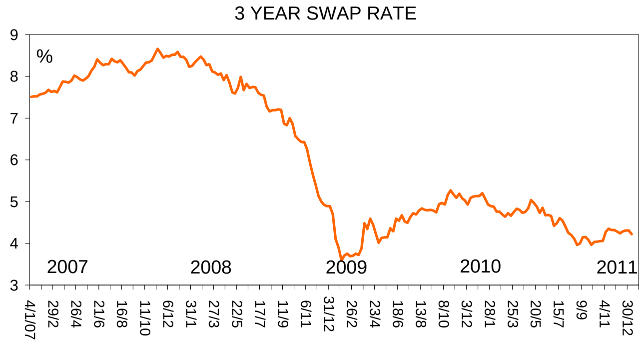
INTEREST RATES

Our current expectation is that the Reserve Bank will next raise the official cash rate in June and the rate will peak at about 5% come the first half of 2012. Around the planet practically everyone's monetary policy forecasts for Western economies have proved wrong in the past year and the chances are near 100% that the common pick for NZ rate movements will also change. So have we learnt anything really interesting over the past month to cause us to alter our current view? Also, has any new stuff appeared to alter our current broad feeling regarding fixed interest rates drifting higher as the year progresses, credit demand and inflationary pressures rise, and foreign rates creep up?

One sort of important but also well out of date development was the reporting before Christmas of a 0.2% fall in gross domestic product during the September quarter. The result was weaker than our +0.1% expectation, the market's 0.2%, and the Reserve Bank's 0.3%. The importance of the result is not that it gives any insight into how things are going now, but it suggests that at the margin there is more capacity in the economy to handle growth over 2011 than previously thought therefore the result reduces the chances that monetary policy will tighten again in June. In consequence this reduces the need for active scanning of fixed interest rates in case they jump up any day soon.

Apart from that the NZ dollar has gone higher thus taking some pressure off the RB to tighten, but commodity prices have risen further and US economic data have been stronger than expected. The bits and pieces do not fall strongly one way or the other so unsurprisingly we have NZ wholesale interest rates now about where they were in the middle of December. 90-day bank bill yields remain close to 3.2%, the one year swap rate is unchanged near 3.45%, the three year is down closer to 4.2% than the previous 4.3%, and the five year rate is near 4.8% from 4.85%.





A key area of uncertainty for the medium to long term part of yield curves this year will be the extent to which investors are willing to stump up funds for banks who must increase their long term funding and reprice upward old pre-crisis funding now rolling off, and governments who have substantial deficit funding requirements. In 2007 in wealthy countries the ratio of government debt to GDP was near 35%. It is now near 70%. It is estimated that the US Federal government will need to raise and rollover some US$4tn in debt this year while the EU must do the same for near US$3tn. Japan's funding requirement will be around US$2.3tn.

Key Forecasts

- Tightening through to mid-2012 with the next rate rise in June.

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	3.23%	3.19	3.20	3.20	2.79	6.2
1 year swap	3.42%	3.44	3.45	3.48	3.75	6.3
5 year swap	4.78%	4.90	4.86	4.39	5.68	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

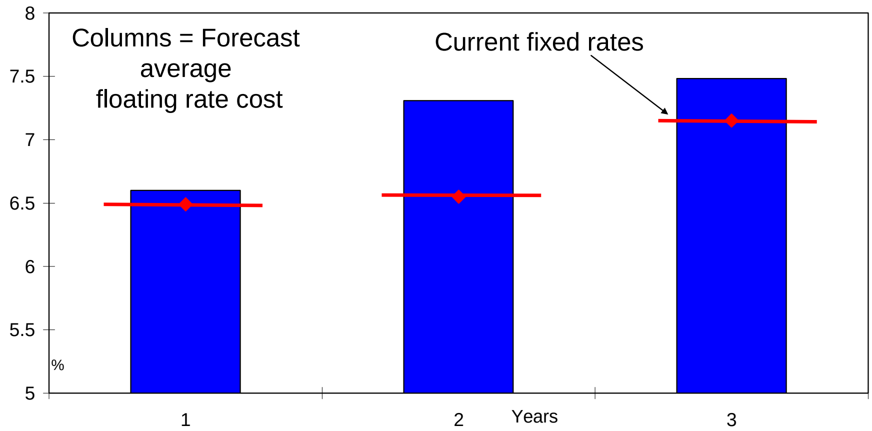
* 160 days = 5.2%

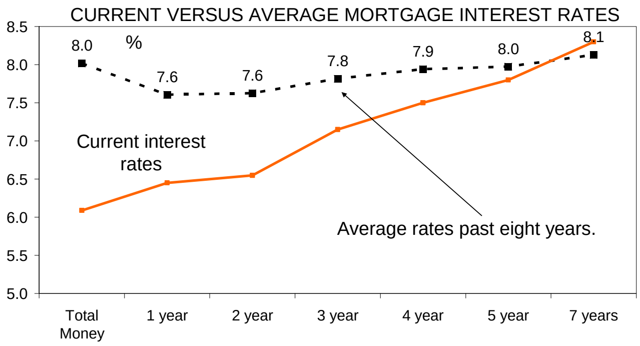
If I Were a Borrower What Would I Do?

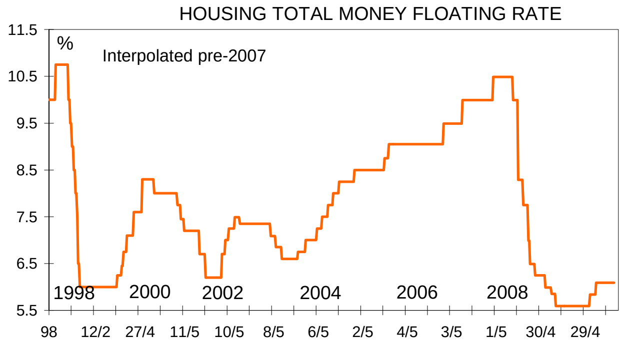
I'd just be lying back thinking how great it would have been to have been paying the current interest rates years ago when I actually had a mortgage – at 18.5% back in 1987. Then I'd give thought to how much I might have borrowed if rates had been this low and how much property I might have bought – and how munted I'd then have been when those interest rates went up during a monetary policy tightening cycle. That is exactly what happened in the US where people got low floating rate (ARM) mortgages then found debt servicing impossible when those rates rose and payment delays brought penalties into play.

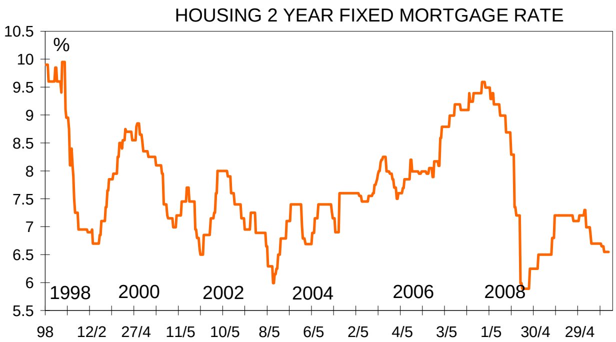
Kiwis who "over-invested" in residential property over the past ten years have in some regard been bailed out of their positions by the events offshore. Overseas people have been hit by a collapse in property prices after and for a while with soaring interest rates. But here we have avoided the price collapse due to an absence of the excess building offshore, yet borrowers have been able to enjoy the lowest mortgage interest rates since the 1960s.

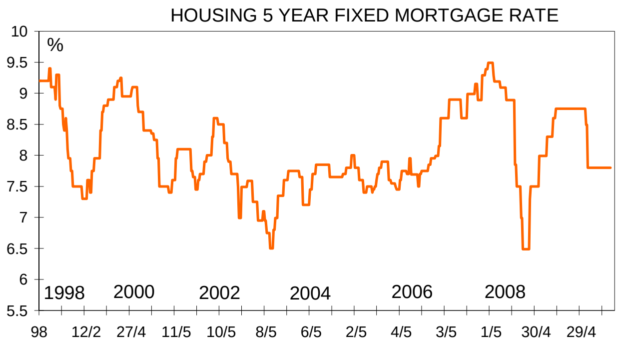
I don't think inflationary risks are great enough that fixed rates or floating rates will be shooting up in the near future. So I would be borrowing at a floating rate of 6.09% and paying off principal as rapidly as possible.





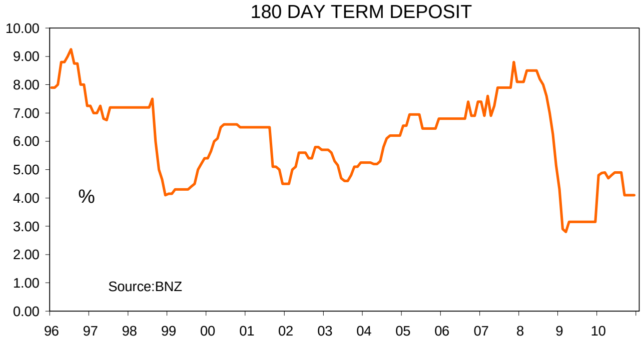


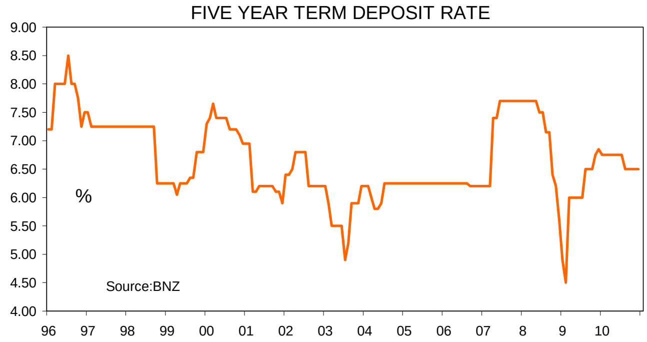




If I Were a Term Deposit Investor What Would I Do?

Take a spread of term rates.



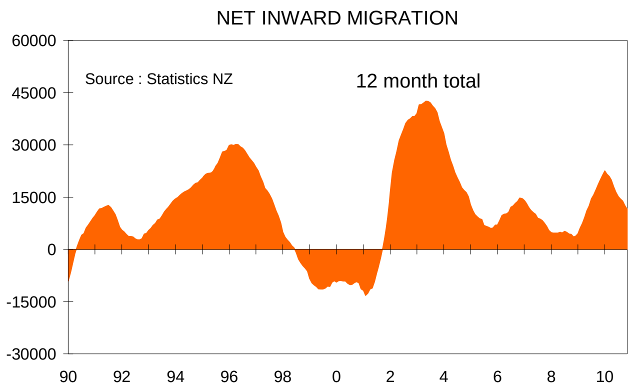


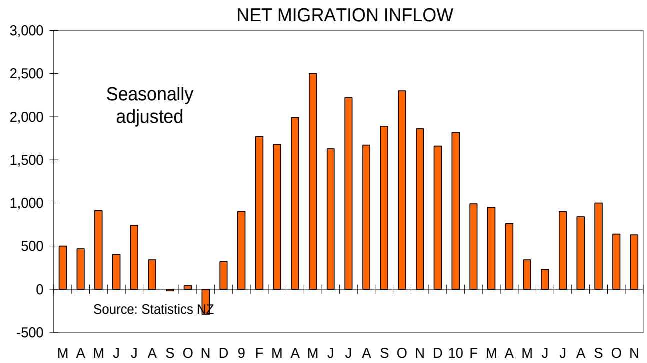
HOUSING MARKET UPDATE

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

We have not learnt anything new and insightful about the NZ housing market since the last Weekly Overview of December 16 so you may as well skip this section. But if you don't want to here are a few comments of no great import.

There is a broad correlation between net inward migration flows and the housing market so it is useful to keep an eye on the monthly migration numbers to see if anything major is happening. It isn't. In November in seasonally adjusted terms there was a net immigration gain for the country of 630 people which was essentially the same as October's 640 people but down from 1,000 in September. This number has averaged 1,328 over the past decade so recent results have definitely been below average but this is not fresh news.





In fact, on average over the past decade there has been a per annum net migration gain of 15,062 people but in the year to November 2010 the gain was just 11,519. Net inflows are therefore weak but not in such weak territory that the impact on the housing market would be noticeable. Consider for example that between early 1999 and the middle of 2001 net annual outflows averaged 10,000 so the latest result is nothing major and to the extent there is a deteriorating trend it is a mild one.

What is it we will be keeping an eye on this year? Obviously the monthly REINZ numbers will give good info on turnover and price changes – though probably still with a downward bias on the turnover numbers as agents no longer need to supply their data to the REINZ. We expect weak turnover until late in the year when we expect a surge in attention being paid to weak construction which will be manifesting itself in accommodation shortages and lots of articles discussing the difference between an oversupply of already occupied houses on the real estate market and an undersupply of all houses when compared with those wanting a place to live.

Imagine especially what the impact will be once the labour market is stronger and those who in the past three years who have delayed setting up their own home or who shifted back in with the folks decide to strike out on their own. Now throw in the absence of much training of builders since the recession started in 2008. Then add in the ongoing attractiveness to builders of shifting to Australia to earn 50% more working in the booming minerals and infrastructure sectors. Now add in the extra people Australia will need to help rebuild parts of Queensland devastated by floods. Then add in the rebuilding of Christchurch.

By the time the average person starts looking for a builder later this year there won't be many around. That will induce extra generalised buying in the housing market which will place upward pressure on prices. But before then we think things will look fairly tepid.

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

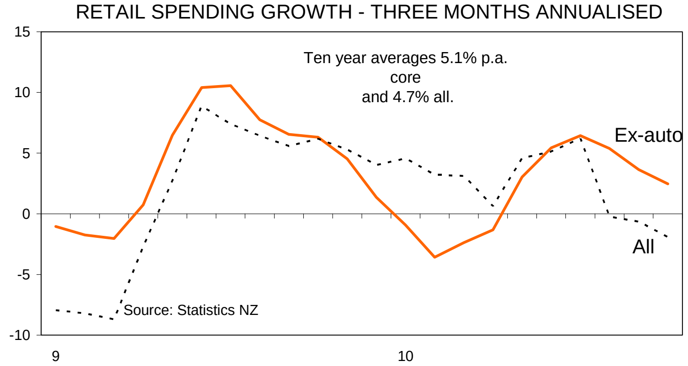
- Dwelling consent numbers to improve further out.
- House prices edging higher from second half of 2011.

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.

About two-thirds of what we households spend each year goes through retail stores and the sector along with wholesaling employs about 400,000 people. The sector currently is experiencing tough times as you and I decide to get our debt down rather than chasing yet another shiny thing we will tire of a few months down the track. Changes in retail spending can impact on monetary policy prospects and therefore interest rates and the exchange rate. So as an experiment we shall devote a section to retailing focusing not just on actual data which will already be discussed in summary form in the early WO section "Is our economy getting better or worse?", but factors which will influence future spending strength.

So what is the latest information we have on growth in retail spending? First, the anecdotes as regards pre and post-Christmas spending were largely weak – the same as those in Australia but not in the US where strong retailing has been reported. Second, data heading into the end of the year were weak. Core retail spending fell away by 1.7% in October after rising the same in September showing any pre-GST buying was easily wiped out and more in October. The Statistics NZ trend measure of monthly growth has been getting less and less strong since July and if we annualise the recent core measure growth was a really miserable 2.5% in the three months to October from 6.4% in the three months to July. We have pulled our horns in recently, hence the massive summer discounting by retailers and why we think the absence of e Christmas New Year boom will see more "rationalisation" in the retail sector.



With regard to what we have picked up regarding seasonal spending offshore it looks like sales were brisk in the United States while in Australia they were weak. The Australian retailers Association reported that 45% of retailers experienced sales lower than a year earlier in the week before Christmas. But across the ditch the focus is not so much on the strength of shopping over the Christmas New Year period but on efforts by large retailers to force consumers to pay more for imported products. An advertising campaign organised and paid for by large retailers is backfiring in spectacular fashion as individuals, commentators and some politicians see it for what it really is – a good old fashioned protectionist call by a profitable sector seeing customers exercising their free choice to purchase elsewhere. Of course they do still have an argument with regard to imported goods valued below AU$1,000 not attracting GST. But seriously folks. The rate of GST in Australia is 10%, ours is 15% and there is no great worry here about people shopping on-line and “unfairly” depriving NZ retailers of their revenue.

Opps, having said that, with the Aussie retailers stirring the pot the NZ retailers have decided to raise their protectionist voices a bit in me too fashion. The key problem for the retailers is that it would apparently cost the government more to collect the money than dropping the NZ exclusion rate to $0 would collect. Given that gift duty is being removed from October 1 this year because collection costs exceed receipts there is no chance of GST being applied to all imported consumer goods here.

This year we expect retail spending growth will slowly improve in response to jobs growth, an eventual lift in house building late in the year, and the simple passage of time taking more people to a point where they are happy with their debt levels. But there are many factors which suggest retailers should definitely plan for a still mild year, keep stocks low, and not believe in the sustainability of any rise in household spending until it has been underway for perhaps three months.

- Debt repayment is the focus of households in the Western world and no-one has the foggiest idea when this attitude will change.
- Net inward migration flows are likely to fall further as we lose people to Australia. The latest data are discussed just above in the Housing section.
- On-line shopping direct from overseas manufacturers is growing strongly in Australia with people seeking to avoid GST. In the US people increasingly use the likes of the smartphone applications TheFind and RedLaser for instantly comparing prices found in a retail shop with those online and at other shops. Price search costs to consumers are collapsing (this is fantastic) but it means a whole new world of competitiveness for retailers. It would be very surprising if the same trend does not accelerate here.
- Real estate turnover is likely to remain low until late in the year. Same for house construction.
- Farm incomes are rising but farmers have had many shocks – debt, weather, disease – and we suspect debt repayment will remain the prime focus this year.
- Tourism is likely to be flat.
- Consumers will have spending power hit by rising petrol and food prices.

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.

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?
Late-December Moody's cut Ireland's credit rating five notches from Aa2 to Baa1 – just three notches above junk bond status. Their concern is failure of economic growth to achieve forecast levels will worsen the already dire fiscal situation and that banks have more losses to be revealed. The message to investors is that their worries warrant being greater than they were so this heightens the risk of further investor withdrawal from government bond markets. Watch early this year when a general election in Ireland will give victory to the current Opposition – will they try to renegotiate the terms of their bailout and scare investors even more?

On December 21 Moodys warned that they may downgrade Portugal's rating two notches – just one week after a similar warning for Spain.

Speaking of Spain – fears are growing that with house prices reported as down only 13% from their peaks in spite of massive numbers of empty flats, that the data are wrong and banks have billions and billions of losses yet to go on their books. But compared with other countries lending ratios are usually low near 60% of valuation and for owner-occupancy rather than investment. At 53% of GDP Spanish government debt is low, but regional government, household and bank debt is large and there are fears the government may end up like Ireland's – having to take on non-government debt to stop the financial system collapsing. (Hence why although NZ government debt is low high household debt occupies the minds at Standard and Poors.")

However on a positive note for Spain it is expected the government will do better than its target of shrinking the deficit to 9.3% of GDP this year and numbers unemployed unexpectedly fell 0.25% in December.

After a two day meeting EU leaders agreed on a permanent bailout fund after the current €750bn one ends in 2013 but with each case taken on its merits and the door left open for bond holders to bear some of the losses as it is so blindingly obvious they should. Germany and France batted away talk of issuance of Euro-zone bonds backed by all. Why do many support such issuance? Because the issue here is that some individual Euro-zone member finances are crap, but the zone overall looks good with public debt at 92% of GDP = the same as the US and a tad more than the UK at 78%, but the aggregate budget deficit is picked at just 6.3% of GDP versus 11.3% for the US and 10.5% for the UK. French and German citizens however have reached their limits on how much wealth they are willing to transfer to their economically retarded southern cousins.

For your guide, Euro-zone economies must raise about €1.5tn in debt this year. That means wariness of investors regarding willingness to take on more debt will be at the forefront of news items the entire year – and beyond especially as many big voices such as DSK (Dominique Struass-Kahn) of the IMF feel the authorities are still behind the curve with regard to investor concern about Europe's problems.

The Chinese are increasing their purchases of Euro-Zone country debt as a means of diversifying risk away from the US dollar plus who knows what favours to be asked for in return.

General commentary is in the process of shifting toward the inherent inability of the Euro-zone to be sustained unless there is also fiscal union – as so many commentators pointed out over a decade ago. There is increasing talk now of a United States of Europe and while no such union is likely in the near future European politics will be filled with countries, organisations and even individuals positioning themselves for such an eventuality some years down the track.

Euro-Zone inflation has risen above the ECB 2% target to reach 2.2% over calendar 2010 from 1.9% in the year to December. This sounds like something which could bring forward monetary policy tightening which would make debt financing even more of a problem for European states. But because the hike in inflation seems to stem mainly from food and energy and the underlying core measure is closer to 1% than over 2% it is unlikely the ECB will do more than make some cautionary comments regarding the situation. Greater ECB focus may be on rising wage demands from German workers who have exercised restraint for a decade but now want some income payback at a time when labour demand is high and their economy is growing well.

For this week the markets are taking the glass half full approach to the European debt situation so sharemarkets have been firming and rates paid by the highly indebted countries to borrow funds have been generally falling compared with German borrowing costs. This won't last.

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 thing of most significance following the revelation in mid-December of inflation hitting 5.1% was the Christmas Day decision by the People's Bank of China to raise interest rates. The one year benchmark lending rate was increased 0.25% for the second time in ten weeks to reach 5.81%. The benchmark deposit rate was also raised 0.25% to 2.75%. Asian sharemarkets rose after the increase on expectations that the rise will go a long way toward curbing household spending and therefore allow firm economic growth to continue. A glass half full interpretation which is one reason why forecasting financial asset prices is often a dogs breakfast. You can never be certain when the collective interpretation of a thing will be on the optimistic (it works) side or pessimistic (it will ruin things) side.

Other measures beyond rate rises being implemented to try and stem house price inflation in particular include a ban on mortgages for third home purchases and a big boost of subsidised house construction to 10 million units this year from 3.7 million last year. Last year bank reserve asset requirements were also lifted six times. More increases are likely this year.

The authorities have also eased (removed?) the long standing rule requiring exporters to surrender practically all their FX earnings for conversion into Yuan. This requirement helped contribute to the fast money supply growth feeding inflation. But for the moment it is likely most exporters will continue to swap their earnings into Yuan which on average according to surveys is expected to be allowed to appreciate 6% this year.

In a sign that maybe tightening monetary is affecting industry the monthly PMI index compiled by the Chinese government eased to a still above 50 growing level of 53.9 in December from 55.3 in November. The graph shows no big downward trend is underway. But keep an eye on this measure because if it dips again in January and then again in February this will be taken as a sign that the Chinese economy is slowing aggressively and that sort of conclusion will weigh heavily on commodity prices and risky currencies like the AUD and NZD.

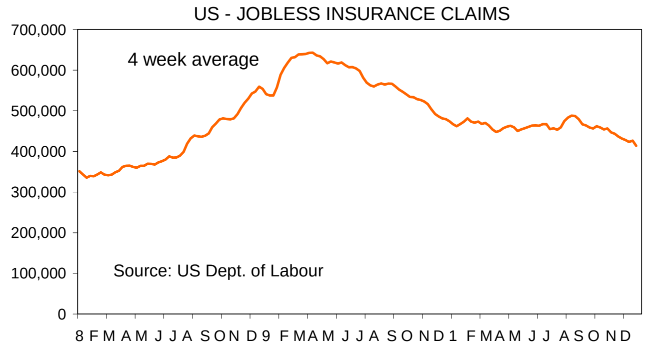
US Growth Momentum

The US economy has grown 2.2% over the past year but the upturn is not yet "self-sustaining" or reducing unemployment stuck near 10%. Manufacturing is firm but retailing, housing and business investment remain weak while no 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?

Most but not all recent data releases have been better than expected so a glass half full phase is underway. This has led to the sharemarket rising 6.6% since the end of November and the ten year government bond yield jumping from 2.79% to 3.46%. Investors are puffed up regarding the extension of Bush era tax cuts brining almost a US$900bn fiscal injection over the next two years, continued money printing by the Fed. and very good retail spending reports.

Weekly jobless claims have been falling thus suggesting the labour market might be finally improving. This Friday however the proof of the pudding will be in the monthly non-farm payrolls report.

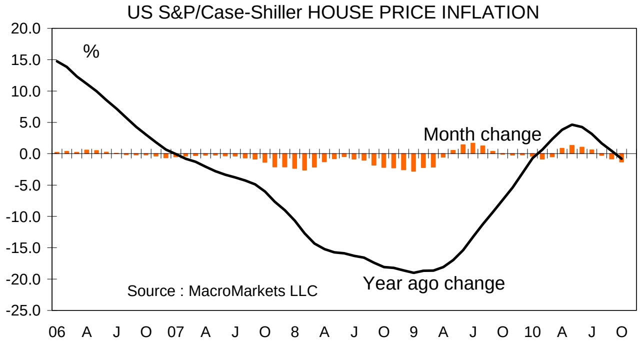


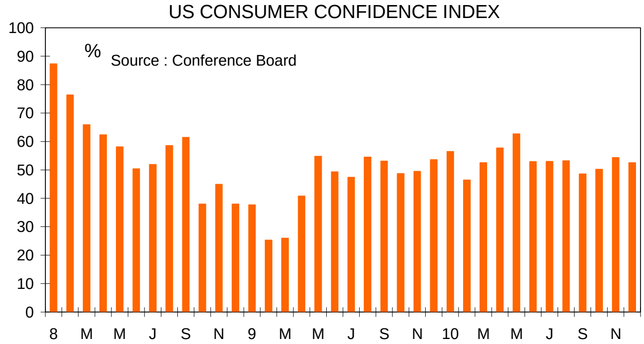
The yield curve has steepened meaning investors are increasingly confident growth will prove sufficient in the future (or at least that inflation goes up) that the Fed. will need to tighten monetary policy. The steeper the curve the greater those growth/inflation/policy tightening expectations.

The rate of growth in the US economy over the September quarter was revised upward just before Christmas to an annualised rate of 2.6% from 2.5% which was a tad less than the 2.8% expected but no-one was all that worried because the US economy is seen as having more momentum now than a few months ago with assistance in particular from the money printing and tax cut extension.

Anecdotal reports of Christmas New Year shopping have been surprisingly strong. But we are only talking about a short period of time so we don't think one would be justified in blindly extrapolating these many good reports into a big turnaround to the positive in US household spending. But remember, if this does turn out to be the start of a decent lift that will only start the markets to thinking about the Federal Reserve being given some space to put interest rates up late this year and maybe not complete the US$600bn bond buying programme. One would watch also for more solid discussion about fiscal tightening though the rocks in the road for that problem seem massive and big turbulence in coming years from this issue is highly likely.

The housing market remains very weak (demand dead in the water according to one analyst because 30% of sales are foreclosures) with growing worries about increasing foreclosures and evidence of falling prices. A double-dip appears to be at hand and this calls into question the sustainability of the retailing upturn unless the labour market improves substantially. The monthly S&P Case Schiller House Price Index – widely considered the best measure of house price movements – fell by 1.3% in October after declining 0.8% in September and 0.3% in August. The 2.4% fall over the three month period means the average house price in October was down 0.8% from a year earlier which is the first annual rate of decline since January.

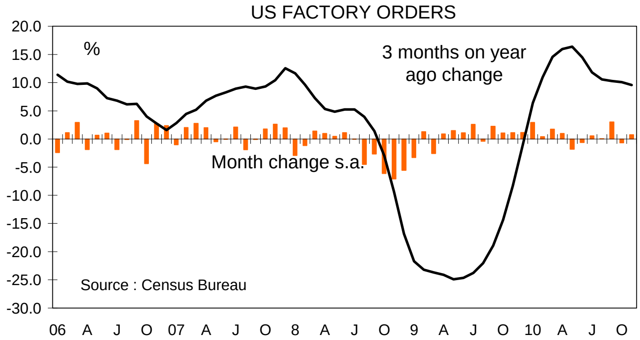




One can also seriously question the sustainability of the summer retailing improvement on the basis of one of the heavily watched consumer confidence measures – from the Conference Board – falling to 52.5 in December from 54.3 in November.

Moody's Analytics estimate that for the first time in two years quarterly lending to the commercial sector appears to have improved with a rise near 0.2% over the December quarter. If so, and if this continues, then this would be an important step with regard to the US export and manufacturing led upturn becoming self sustaining as it suggests improving business capital spending along with perhaps greater willingness by banks to lend.

The manufacturing sector continues in good health with orders to manufacturers rising a seasonally adjusted 0.7% in November after falling the same amount in October. In the past three months orders were 9.6% ahead of a year ago and up 3% from the three months to August. The manufacturing sector is one of the points of strength in the US economy. But as we have noted, the big interest is in whether this strength is going to be seen in retailing, housing, and capital expenditure.



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?
Nothing much but this month the French President will visit US President Obama and start more solid work on his goal to shift the USD's role as a reserve currency to one amongst many rather than the preferred reserve asset. The Chinese want this as well though with the IMF's Special Drawing Rights becoming the main reserve currency. Presumably a reduced reserve role would see the greenback weaken. But that is hardly what the Chinese or other countries want and the US will rightly fear that not so much the weakening but the loss of special status will see reduced investor tolerance of the US deficit problem. That is, the US could experience the same market-driven pressure producing rising interest rates, weak confidence and fiscal austerity bombshells currently occurring in Europe. Plus the implied recognition of the diminished US global status is hardly likely to be a message the US President will want to send leading into the 2012 US Presidential election year, especially as loss of such a status will mean higher interest rates on average.

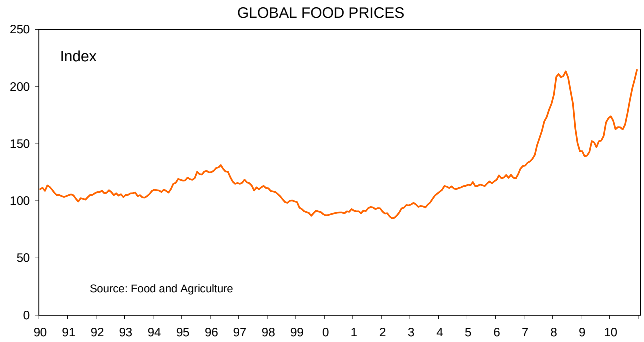
Any timetable for a change in the USD's reserve asset role is likely to accrue over a period of years exceeding a decade – if it happens at all given that alternative candidates like the Yen, Pound and Euro look very dubious.

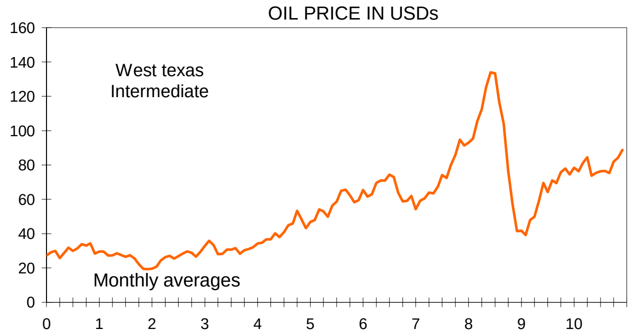
It is probably not stretching things too much to believe that the Chinese view permitted currency adjustment as a trade weapon to be kept in reserve for delivering a favour if they get their way in other areas. Unfortunately for those hoping the Chinese may feel magnanimous enough to allow faster Yuan gains the news on the trade front has been a bit rough recently for the Chinese. They have lost the case taken to the WTO regarding subsidies on type exports to the United States. Now, perhaps emboldened if not embiggened by that victory the Americans have taken a similar case regarding what they believe are Chinese subsidies on their exports of wind turbines. Yet in spite of their worries about China's trade the country receives a stream of foreign leaders with businesspeople in tow seeking increased trade.

Late in December Brazil, who's currency has risen 100% against the USD since 2003, took moves to protect domestic manufacturers against increasingly cheap imports. They raised tariffs from 20% to 35% for 14 categories of toys. However the government has also announced a tightening up of fiscal policy in order to take some of the strain off monetary policy (high interest rates attracting foreign capital).

Commodity Prices

Over 2010 prices for commodities soared in spite of weak Western world growth. Gold is up around a quarter but silver prices are ahead near 75%, palladium near 85%, copper near 3%. Of great concern however is the sharp 25% lift in global food prices last year which takes the Food and Agricultural Organisation's index back almost to where it was in 2008 when there were shortages and riots in poor countries – while for us we also had rising food prices but high export prices. Oil prices have also just hit a 26 month high and this is going to lead to higher NZ petrol prices soon while crimping growth in oil importing countries.





Prices for minerals and food items are surging anew on the back of continued expectations of structurally higher demand out of Asia, recent weather events (floods in Australia), some better data out of the United States and a disconnect between Europe's debt worries and economic growth expectations, plus speculative pressures. This last factor is the big worry because it could unwind at any time – or it could soar even further thus pushing up input prices for manufacturers, food prices for consumers (think milk and cheese), and of course fuel prices. The common view has become that oil will soon be above US$100 a barrel after rising above a 26 month high of US$90 for the first time since October 2008 just before Christmas. The peak two years ago was US$140.

Iron ore – India has banned exports in order to ensure their own supply. China steel industry recovering.
Wheat, sugar and cotton – floods in Australia
Wheat – dry conditions in North and South America (especially Argentina, Brazil and Uruguay), increased stockpiling by Egypt, the August 5 ban by Russia on wheat exports, continued ban on pulse exports from India plus a post-Christmas decision to rundown grain stocks in order to keep local food prices down. Also India subsidises firms to import grain from overseas.
Coal – cold weather in Europe and parts of the US, flooding in Queensland.
Copper – increasing worries that global production is in long term decline plus hopes of strengthening US manufacturing sector demand as PMI readings continue to improve.

Gold – worries about inflation from US money printing, fleeing European debt exposure, low relative holding cost given continuing low interest rates on alternative investments, rising industrial demand from Asian urbanisation, rising jewelry demand from rising Asian incomes, gold's role as effectively an alternative currency at a time when other candidates each have major problems, expectations of additional Fed. money printing based on the Fed/ Chairman not ruling such a move out, plus general fears that the global financial crisis has much further to go. On top of that there is pure and simple unquantifiable speculation and herd following. Gold prices increased about 30% over 2010.

Oil – expectations of firm world growth, Asian structural demand rise. But no supply disruptions currently.

Rare earths – shooting up on tightening Chinese export restrictions. On December 28 the Chinese announced a 35% cut in rare earth export quotas for the first half of this year compared with the same time last year. Their aim is to force Western technology companies to relocate production facilities to China with the excuse being concerns about the environment. How nice. The Chinese use of their 95% dominance in rare earth production as a trade weapon is reshaping the approach countries are taking in their relationship with China, helping to spur a military build-up in Japan involving reallocation of forces to the south and a probable military alliance with South Korea alongside the two existing ones with the US and Australia, increased US naval presence and heck, maybe even the welcome rejection of a bid by Chinese investors headed by a now bankrupt individual to secure a decent foothold in New Zealand's most important industry dairying.

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.

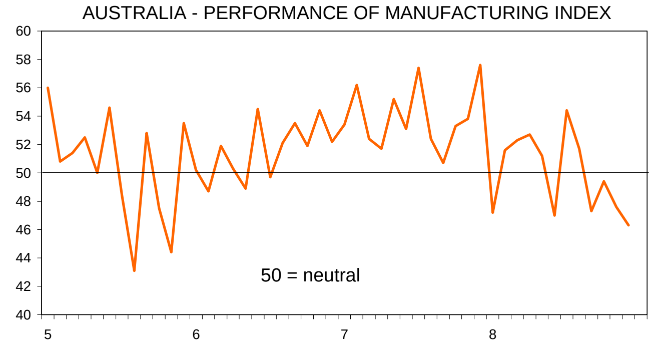
What's new?

On December 21 the Reserve Bank of Australia released the minutes of their December 7 Board meeting and basically said that in light of increased bank lending rates following the cash rate rise in November, plus taking into account the high terms of trade and positive business investment, monetary policy is appropriate to be at its current "mildly restrictive" setting. They are keeping a close eye on the European debt situation out of fear it could all blow up and worsen Australian growth prospects, but noted growth is improving through Asia and even the US is looking a tad better – growing at a "modest pace". They noted that continued weakness in consumer spending and borrowing is "making room" for the booming mining and infrastructure sectors.

If you sell stuff to Aussies and it ends up being bought by consumers then prospects for the first half of the year don't look like improving all that much from the latter part of last year as consumers continue to look at their fast growing economy from a glass half empty position. That is, debt repayment rules. A Newspoll survey taken from December 3-5 found that a net 7% of people expect their standard of living will get worse over the next six months. In the middle of last year this reading was a net 1% positive.

Speaking of the first half of the year, for perhaps half of that experts across the ditch now expect weak exports due to the extreme flooding in Queensland and north New South Wales which is hitting not just agricultural production but also forcing the closure of mines. The floods are estimated to take at least 0.3% off GDP but at the same time cause higher inflation by about 1%. However given the likely temporary nature of this inflation the RBA is not expected to accelerate interest rate rises and we expect rises to still come in May and August taking the cash rate to 5.25%.

The Australian manufacturing sector remains in recession and in fact amongst the countries for which the monthly Performance of Manufacturing Indices are compiled it is the second weakest after only Greece with a reading of 46.3 in December. The sector is weighed down partly by the high Aussie dollar and partly by the diversion of people and capital toward the mining and infrastructure sectors.



Exchange Rates

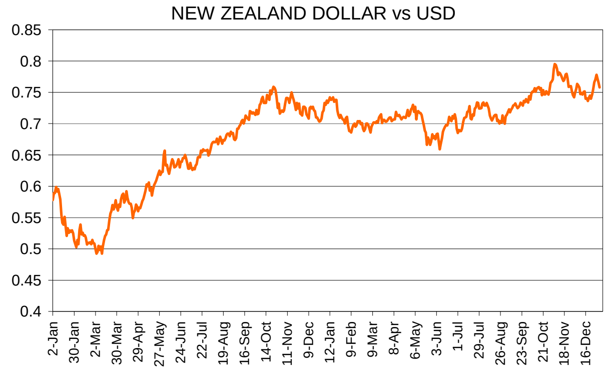
Exchange Rates	This Week	Week Ago	4 wks ago	3 mths ago	Yr ago	Consensus Frcsts yr ago*	10 yr average
NZD/USD	0.758	0.770	0.764	0.748	0.73	0.690	0.629
NZD/AUD	0.758	0.758	0.771	0.771	0.805	0.772	0.855
NZD/JPY	63.100	62.900	63.150	62.300	67.1	66.999	68.4
NZD/GBP	0.489	0.499	0.484	0.471	0.458	0.426	0.368
NZD/EUR	0.576	0.579	0.570	0.541	0.51	0.495	0.511
USD/JPY	83.245	81.688	82.690	83.244	91.918	97.100	109.9
USD/GBP	1.550	1.543	1.577	1.589	1.594	1.620	1.705
USD/EUR	1.316	1.330	1.339	1.383	1.431	1.394	1.229
AUD/USD	1.000	1.016	0.990	0.971	0.907	0.894	0.737

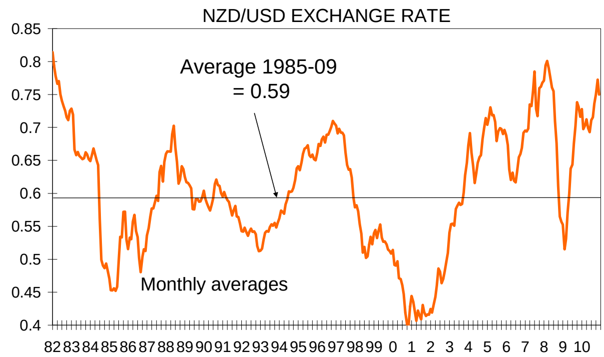
Just briefly in the interests of containing the length of the WO this week…..

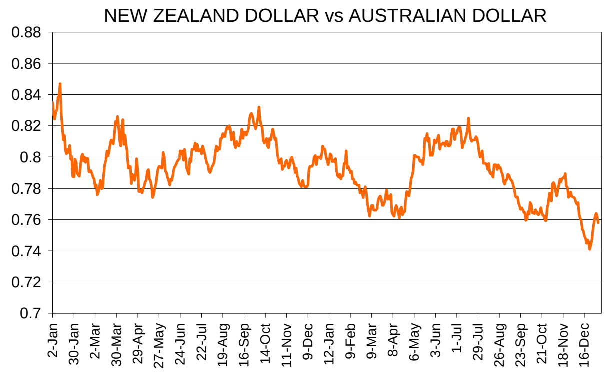
In the middle of December when the WO was last produced the NZD was trading against the greenback near 74 cents. Now we are just under 76 cents and traded near 78 cents at the start of the year offshore. We went above 50 pence for a while but are now near 49 from 47.5 three weeks ago, while against the Euro we traded near a five year high close to 58.5 centimes but are now near 57.5 from 56 three weeks ago. Against the Yen nothing of interest has happened and against the AUD we remain weak under 76 cents from 75 cents three weeks ago.

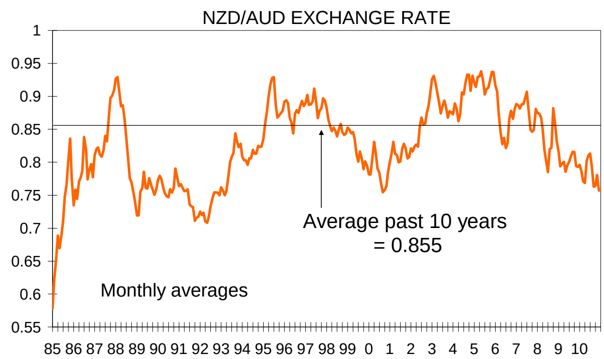
The firming of the NZD up until a few days ago can be put down to thin trading conditions, rising risk tolerance associated with good US data and nothing new and horrible for a while on the European debt crisis, plus rising NZ export prices. At Fonterra's fortnightly auction for instance this week average prices were ahead another 7%.

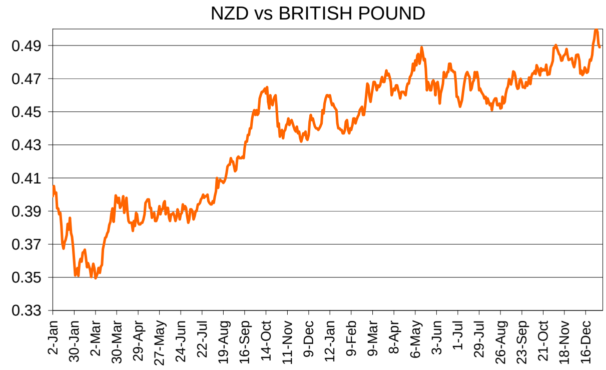
Looking ahead to 2011 our general expectation is that the NZD will remain well supported by high export prices and improving risk tolerance. But the list of uncertain factors is long and contains some biggies. So high volatility is virtually guaranteed and those with FX transactions to undertake are likely to see opportunities present themselves during the year to get some reasonable levels locked in. Enjoy the ride.

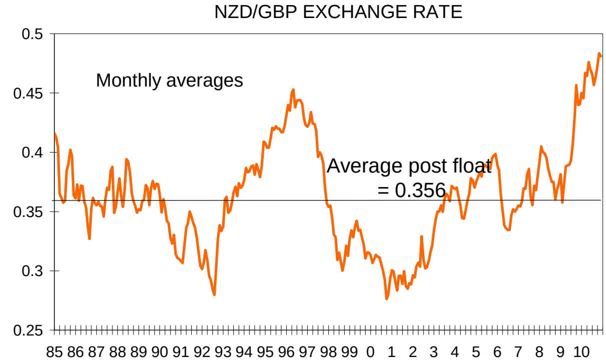












For more detailed commentaries from BNZ and the NAB group on foreign currencies, commodities, etc click on the following link.
https://research.bnz.co.nz/Research/Pages/default.aspx

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

ECONOMIC DATA

All %		Latest qtr only	Previous qtr only	Latest year	Year ago	2 Yrs ago
Inflation	RBNZ target is 1% - 3% on average	1.1%	0.2	1.5	1.7	5.1
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	-0.5	-1.1	-2.2	5.6	-8.2
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	-15.2	-35.9	-17.2	41.5	-45.4
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